Select Corporate Migration and Combination Considerations in an Ever Changing Environment

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I. Introduction

The world of corporate migrations, "inversions" and other cross-border combinations has involved an ongoing and evolving landscape of transaction structures, statutory provisions and regulatory and other guidance.[1] There have been significant developments in this area just in the last few years. Ensco International, a U.S.-based oil drilling company, redomiciled to the United Kingdom in late 2009 and opened a new global headquarters in London in early 2010.[2] At the time, Ensco was the first major cross-border migration of a U.S. multinational since significant modifications were made to the Code Sec. 7874 regulations in early summer 2009. This paper is intended to highlight some key developments in this area since that time. It is not intended as a comprehensive study or policy piece—there are other articles that are helpful in that regard.[3]

In addressing more recent developments, it is helpful to review some of the relevant history. It is probably fair to characterize corporate migrations, inversions, *etc.*, by reference to cycles of corporate activities, followed by government reactions, followed by a cycle of decreased corporate activity, followed by an uptick in corporate activity and government responses and so forth. This has happened repeatedly over the years—we are likely in at least the fifth cycle (depending on how one counts the cycles).

The first cycle was marked by the well-known McDermott International inversion.[4] In this transaction, an existing CFC of McDermott acquired McDermott shares from the public in exchange for the CFC's own shares and cash. McDermott, previously a U.S. multinational, ended up a wholly owned subsidiary of its former subsidiary. It also held substantial "hook stock" in the former CFC. This transaction not only inverted the U.S. parent, but "decontrolled" the acquiring CFC for subpart F purposes.[5] In response, Congress enacted Code Sec. 1248(i),[6] which generally requires the former U.S. parent in a situation like this to include in income the Code Sec. 1248 amount of the CFC. While this provision slowed things down for a while, Code Sec. 1248(i) by definition has a limited scope and application. For example, it has no application or effect when the inversion is into a subsidiary of a newly formed foreign corporation. As a result, Code Sec. 1248(i) was not able to stem the next cycle of inversions.

The next cycle was marked by the well-known "Helen of Troy" inversion in 1994 (followed later by Fruit of the Loom and other transactions). The Helen of Troy transaction involved an internal restructuring of Helen of Troy Corporation, a Texas corporation ("HOT") in a transaction designed to avoid Code Sec. 1248(i)—it was moved under a newly created foreign corporation without an earnings and profits ("E&P") history. The transaction was successfully completed (and apparently survived IRS examination). This second wave of inversions raised great concerns. In response, the Treasury and the IRS issued Notice 94-46,[7] which led to temporary and proposed regulations,[8] and then final Code Sec. 367 regulations,[9] now found in Reg. §1.367(a)-3(c). These regulations require gain, but not loss, to be recognized on the exchange by the U.S. shareholders of their stock in the former U.S. parent. Thus, unlike Code Sec. 1248(i), the Code Sec. 367 rules apply at the shareholder level, rather than at the corporate level. These regulations initially had a chilling effect on corporate migrations (they still do in some cases).

However, ultimately the Code Sec. 367 regulations did not stop the third cycle of inversions because the shareholder level tax proved in certain cases not to be an effective obstacle. This next wave arose largely in the late 1990's and early 2000's. It was marked perhaps by even more transactions and involved, among other companies, Ingersoll Rand, Cooper Industries, Transocean, Arch Capital, Global Marine, Foster Wheeler, Noble Corp. and Nabors Industries. These inversions typically involved migration to a tax haven jurisdiction like Bermuda or the Cayman Islands, often with tax residence in Barbados to take advantage of the then existing U.S.–Barbados Treaty. For this wave of inversions, the Code Sec. 367 regulation shareholder level tax proved not to be a deterrent. This was true, in part, because there were often substantial institutional (tax exempt) shareholders who were not affected by a gain recognition provision. It was also true in many cases involving taxable shareholders because stock prices had declined to the point that there often were not significant gains or even losses in the exchanged stock. Even if there were a shareholder level hit, this often would not be an obstacle because the corporate level benefits were so significant that the inversion could effectively be "crammed down" on the shareholders.[10]

The response to this third wave was, of course, the enactment by Congress of Code Sec. 7874 as part of the American Jobs Creation Act in 2004.[11] As discussed in more detail below, Code Sec. 7874 is a corporate level provision (though it can apply in tandem with the shareholder level rules of Reg. §1.367(a)-3(c)). At its worst, Code Sec. 7874 can treat the foreign acquiring corporation ("FA") as a domestic corporation for U.S. income tax purposes. If FA is treated as a domestic corporation, this treatment undermines key aspects of the migration transaction. In its less extreme form, Code Sec. 7874(a) inhibits inversion transactions by limiting certain "out-from-under" planning for 10 years after the inversion by preventing the former U.S. parent from using attributes to offset gain or income.[12]

Code Sec. 7874 significantly limited the ability of U.S. multinationals to freely "self" migrate (it also applies, along with the Code Sec. 367 regulations, to a wide range of joint ventures, combinations, acquisitions, *etc.,*that are *not* classic inversions). At the very least, it has from the start forced companies thinking about doing self migrations to consider only a limited number of potential jurisdictions. In most cases, these have to be "real" (nontax havens) jurisdictions where the U.S. corporation has significant operations, in order to satisfy Code Sec. 7874. There can be more flexibility in the selection of a new FA's jurisdiction in the case of, say, joint ventures with reasonably sized JV partners; but for true "inversions" the choices are more limited. There have, however, been a number of post-Code Sec. 7874 self-inversion transactions, including Ensco, Aon, Rowan and Sara Lee. There have also been a series of "redomicilitations" from jurisdictions perceived as tax havens (Bermuda, *et al.*) to low-taxed, but more "respectable" jurisdictions like Switzerland or Ireland. These transactions were in some cases perhaps reactions to loss of Barbados treaty benefits; they also may have been prophylactic measures in case the United States adopts a "managed and controlled" standard or enacted anti-treaty shopping legislation.

The Code Sec. 7874 regulations have undergone seemingly endless change and revision. Although discussed in more detail below, these changes and revisions have focused primarily on the "ownership" test [13] and the "substantial business activities" ("SBA") test.[14]

The ownership test addresses the level of continuity of ownership between the entity that was the domestic target and the entity that becomes the new foreign parent requiring at least 60-percent continuity for Code Sec. 7874 to apply in the first place. Code Sec. 7874 imposes adverse consequences when the ownership test is satisfied, including potentially treating a foreign acquiring corporation as a U.S. corporation for U.S. tax purposes. Notice 2009-78 outlined certain considerations in the application of the ownership test, focusing principally on ignoring stock of new foreign parent in the denominator of the ownership ratio where that stock was issued for certain "nonqualified property" (*e.g.,* cash). These rules were subsequently adopted in Treasury Regulations and expanded somewhat by T.D. 9654.[15]

The SBA test basically asks in certain circumstances whether there is sufficient "business nexus" to a foreign country to justify having the foreign corporation become the parent of the U.S. corporation. The SBA test, if satisfied, can provide a ticket out of the statute altogether. The rules here have evolved over time. The regulations first provided for (1) a facts and circumstances test *and* (2) a safe harbor (generally looking at having 10 percent of assets, employees and sales/revenues in that jurisdiction). These regulations were then modified because Treasury and the IRS apparently concluded that the safe harbor could be overly generous. As a result, in 2009 the safe harbor was dropped, leaving only the facts and circumstances test. In 2012, however, another change was made and the facts and circumstances test was dropped completely—odd given the clearly factual nature of the SBA inquiry—and a new "bright line" 25-percent standard was employed (again looking to assets, employees and sales/revenue).[16]

The 2009 and 2012 changes basically gave rise to (at least) the fourth and fifth wave of the migration saga. Following the 2009 removal of the safe harbor, taxpayers could still consider an "internal" or "self" migration, albeit without the greater certainty of the safe harbor. This law change to the SBA test was followed by another "cycle" of activity. This included the previously mentioned migration of Ensco to the United Kingdom, the migration of Aon to the United Kingdom, the migration of Rowan (another oil drilling company) to the United Kingdom (a "pattern" perhaps?) and the restructuring and migration of Sara Lee's coffee business, following a spin off to the public, to the Netherlands. Although not eligible for the withdrawn safe harbor, these transactions all satisfied the facts and circumstances test.

Perhaps driven by the fact that these transactions still satisfied the facts and circumstances test, Treasury and the IRS altered the SBA rule once more by eliminating that test in June 2012. Substituted in its place—supposedly because of the government's desire for greater "clarity"—is the "bright line" 25-percent test. This is really not a safe harbor, because it is now the *only* way, and a very difficult one at that, under the Treasury Regulations to satisfy the SBA test. Needless to say, this test was met with criticism from the tax community as a not particularly subtle attempt to stop inversions dressed up in "clarity" clothing. Although it is possible to satisfy this test in extreme circumstances (will discuss the Liberty Global/Virgin Media combination briefly—Virgin Media, a domestic corporation, operates almost entirely in the United Kingdom), most geographically diverse, multinational companies cannot even come close to satisfying this new test. As a result, the current "wave" of activity (fifth we believe) has followed this June 2012 law change. This involves "combination" transactions, typically a U.S. multinational and a foreign multinational where the SBA test cannot be satisfied, but the transaction fails to be caught by, usually, the 80-percent continuity requirement and in some cases the 60-percent continuity requirement of Code Sec. 7874 (the threshold requirements are also tickets out of all or part of the statute even if the SBA test is not satisfied). As reported in the NY Times ,[17] these combination migrations have included Eaton/Cooper, Applied Materials/Tokyo Electron, Actavis/Warner Chilcott, Omnicom/Publicis Groupe, Perrigo/Elan and previously Biovail/Valeant. It is expected at some point that a government response will occur.

The White House recently proposed replacing Code Sec. 7874's 80-percent test with a greater than 50-percent test as part of its fiscal year 2015 revenue proposals unveiled on March 4, 2014.[18] The proposal would also add an override where, regardless of the level of shareholder continuity, an inversion transaction will occur if the combined group has (i) substantial business activities in the United States and is (ii) managed and controlled in the United States.[19] Finally, the proposal would add that an inversion transaction can occur where there is an acquisition either of substantially all of the assets of a domestic partnership (regardless of whether such assets constitute a trade or business) or of substantially all of the assets of a trade or business of a domestic partnership.[20] The proposal, if enacted, would be effective for transactions that are completed after December 31, 2014.[21]

The purpose of this paper is to discuss the evolution of this area and the current landscape for corporate migrations and combinations. Code Sec. 1248(i) is almost never an issue, and the Code Sec. 367(a) shareholder level tax is often not an obstacle. That said, there are planning options for addressing with the Code Sec. 367(a) tax. The current transactional trend, as indicated above, is the focus on combination migration transactions where a U.S. corporation is combined with an unrelated corporation under a new foreign parent corporation (typically in the U.K., Ireland or Switzerland). This paper will first review at a high level the basic rules in this area. It will then discuss in more detail some key guidance and then will address three transactional areas—self migrations, avoiding or minimizing the Code Sec. 367(a) tax and combination migrations.

II. Review of Key Anti-Inversion Rules

The following discussion sets the stage on the key relevant rules and provisions prior to the "recent developments" discussion in Section III of this paper. This is included here for completeness and as basic background.

A. Basic Considerations

The basic tax analysis of an inversion transaction comprises three main areas, regardless of whether the transaction involves an outbound transfer of assets (less common) or stock (most common). First, one must determine whether the transaction qualifies under general subchapter C nonrecognition provisions. If the transaction qualifies under subchapter C (for example, a "B" reorganization or Code Sec. 351 transaction), then Code Sec. 367 must be considered.

An outbound asset transfer of a domestic corporation generally will be taxable under Code Sec. 367(a)(5). That is, where it is not possible to preserve U.S. corporate taxing jurisdiction over the transferred assets, no exceptions under the general gain recognition rule of Code Sec. 367(a) is available. For an outbound stock transfer to avoid the Code Sec. 367(a) anti-inversion rules, four basic requirements must be met (must satisfy all four to be out of the shareholder tax rule):

(1) U.S. shareholders must receive 50 percent or less of the voting power and value in the transferee foreign corporation;
(2) "insiders" must have 50 percent or less of the voting power and value in the transferee foreign corporation after the transaction, without regard to whether the interest was received in the transaction (so "old and cold" stock counts against the U.S. shareholders);
(3) the transferee foreign corporation must be engaged in an active foreign trade or business and be at least equal in value to the domestic target; and
(4) a U.S. five-percent transferee shareholder must enter into a gain recognition agreement.[22]

Where a domestic corporation migrates abroad on its own, Code Sec. 367(a) will apply because these requirements cannot be met. That is, the 50-percent requirements will never be satisfied (all four requirements must be satisfied to preserve tax-free treatment). If the transaction is not an otherwise nontaxable exchange (Code Secs. 351, 361, *etc.*) enumerated in Code Sec. 367(a), then obviously Code Sec. 367(a) does not apply. This may be advantageous if U.S. shareholders have losses they wish to recognize.

Finally, one must consider Code Sec. 7874, which is discussed in detail below. Although the consequences under Code Sec. 367(a) in certain cases can be sufficient to block a migration transaction, the experiences of many transactions, such as Ingersoll Rand, Cooper Industries, Ensco, Aon, Rowan, Sara Lee, Eaton/Cooper and others, indicate that this shareholder level tax often is not an obstacle to completing the transaction. In contrast, only two fact patterns come to mind where a domestic corporation can abide the consequences that result if Code Sec. 7874 applies. First, in an inversion where there is less than 80-percent shareholder continuity (but more than 60 percent) then, as discussed below, the application of Code Sec. 7874 involves some restrictions, but may not be sufficient to stop the transaction. Second, in a very esoteric fact pattern, some businesses may have a nontax regulatory preference for having a non-U.S. corporate parent; in such limited circumstances, the parties may transfer a domestic corporation abroad and not care that Code Sec. 7874(b) treats the foreign acquiring corporation as a domestic corporation for all purposes of the Code.

B. Initial Musings on Code Sec. 7874's Place in the Tax Code

Many international tax practitioners have wrestled with Code Sec. 7874, citing its consequences to break bad news and tell executives of U.S. multinationals with bad facts that an inversion is not a viable option. But how many have stopped to consider why this provision resides in subtitle F ("Procedure and Administration"), Chapter 80 ("General Rules") of the Code? For those practitioners accustomed to life in the 300's, 700's, or even 900's, Code Sec. 7874 is a long way from home. One has to traverse the 5000's, 6000's and chapters with titles like "Machine Guns, Destructive Devices, and Certain Other Firearms" to get to Code Sec. 7874. The reason is that Chapter 80 contains a subchapter dubbed "Provisions Affecting More than One Subtitle," with Code Sec. 7874 being one such provision. And therein lies proof of its broad scope. Congress was serious about slowing down or stopping inversions and wanted to ensure that domestic corporations had a harder time inverting. If an inverted company protests that it no longer wishes to pay employment taxes (the provisions of which are housed in subtitle C), Code Sec. 7874(b) is the answer—providing that a "surrogate foreign corporation" shall be treated as a domestic corporation for all purposes of the Code.

> Following Code Sec. 1248(i), Reg. §1.367(a)-3(c), Code Sec. 7874, several sets of Code Sec. 7874 regulations, Treasury and the IRS may have finally succeeded in most cases with the "bright line" 25-percent threshold rule for the SBA test.

Code Sec. 7874 also contains multitudes of rules. Where else, in one Code section, can one find two punitive rules (the more lenient of which lasts for 10 years), two broad grants of regulatory authority, a treaty override rule, one harmful rule that disregards certain contributions and distributions of property, another rule that disregards certain stock and which could be harmful or helpful and an extended statute of limitations, to name only a few of its features!

Because of Code Sec. 7874's significance, it has received much attention from the tax community, with multiple sets of guidance issued and numerous articles published and comment letters submitted. Nonetheless, despite this attention, the provision's contours remain in many ways less than clear (purposefully so, it seems). All affected will continue to push the evolution of this provision because the stakes are high.

C. Potential Outcomes of Code Sec. 7874

Code Sec. 7874 applies at the corporate level in one of two ways. First, it may prevent an "inverted" domestic corporation from using certain attributes to reduce the tax otherwise owed with respect to gain recognized on "out-from-under" planning during the 10 years that follow the inversion, or with respect to royalty income from property that is licensed to a related foreign person. Second, the provision may apply to treat a foreign acquiring corporation as a domestic corporation for all purposes of the Code. Either, but not both, of these results may occur. That is, a foreign corporation that is treated as domestic is not treated as a "surrogate foreign corporation" for purposes of the attribute limitation rule.

These potential results should be examined in light of what is at stake in a classic inversion transaction. There can be significant benefits from these structures. The potential benefits fall into at least three categories. First, for an inverted U.S. multinational that has not matured globally, there is the opportunity to expand its foreign operations (*e.g.,* by future acquisitions) outside the U.S. tax net. That is, future foreign operations will be acquired and developed under the "foreign" side of FA, rather than under the former U.S. parent. Second, there are opportunities for injecting tax-efficient leverage into the former U.S. parent (still likely the parent of a U.S. consolidated group). Tax-efficient leverage involves a number of factors including (1) deductibility of the interest in the United States (subject to debt/equity and Code Sec. 163(j) considerations), (2) interest payments not subject to significant U.S. withholding tax (typically by means of a bilateral income tax treaty), and (3) low or no taxation to the interest recipient (both locally and under provisions like the subpart F rules). The final area of meaningful tax planning in connection with an inversion is so-called "out-from-under" planning. While the range of this type of planning was narrowed by Code Sec. 304 legislation enacted in 2010, opportunities still exist.

D. Conditions to Apply

Three conditions must be satisfied, pursuant to a plan (or a series of related transactions), for Code Sec. 7874 to apply to a transaction. First, a foreign corporation must acquire, directly or indirectly, substantially all the assets of a domestic corporation (or substantially all the properties constituting a trade or business of a domestic partnership). Second, after the acquisition, 60 percent or more (by vote or value) of the foreign acquiring corporation must be owned by former owners of the acquired domestic entity by reason of such owners' interest in such domestic entity. And, third, after the acquisition, the expanded affiliated group ("EAG") that includes the foreign and domestic entities does not have SBA in the foreign country in which the entity is created or organized, when compared to the total business activities of the EAG.

If each of these three conditions is satisfied, then the acquiring foreign corporation is a "surrogate foreign corporation." Where the ownership continuity is at least 80 percent, then the surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code. The requirements of Code Sec. 7874 illustrate its focus on "classic" inversions of the type undertaken by Ingersoll Rand or Cooper Industries. That is, inversions where (1) most or all of the U.S. parent is acquired (the "sub all requirement"), (2) most or all of the former shareholders of the U.S. parent become shareholders of the new FA (the shareholder continuity requirement), and (3) the FA is incorporated in a tax haven jurisdiction where there are few meaningful or historic assets (the substantial business activities requirement). Of course, despite this focus, Code Sec. 7874's application goes well beyond the traditional or self migration.

1. First Condition: Acquisition of "Sub All"

"Direct" acquisitions represent a very limited range of transactions in comparison to the expansive treatment of "indirect" acquisitions. The former covers outright acquisitions of assets from a domestic corporation or partnership and nothing more. Each item on the following list constitutes an "indirect" acquisition of assets:

- an acquisition of stock of a domestic corporation;
- an acquisition of a partnership interest; and
- an acquisition by an acquiring subsidiary or acquiring partnership in exchange for stock of a "foreign issuing corporation" that is a member of the acquiring entity's EAG (treated as an acquisition by the foreign issuing corporation).

Note that acquiring stock of a foreign corporation is not treated as an indirect acquisition of any properties of an underlying domestic corporation (or partnership).

If, pursuant to a plan, multiple foreign corporations acquire a portion of a domestic corporation's or partnership's properties, then each foreign corporation is treated as having acquired all of the properties. Accordingly, splicing up the target's properties does not avoid satisfying the "substantially all" requirement.

There is no guidance on the meaning of "substantially all," although government officials have indicated that future guidance may address the issue. For now, there is only the following mercurial statement in the Senate Committee report: "It is expected that the Treasury Secretary will issue regulations applying the term 'substantially all' in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code."

2. Second Condition: Shareholder Continuity of 60 or 80 Percent

To date, the government has paid significant attention to the "ownership" condition. The first sets of guidance focused on a special provision that disregards stock of the foreign acquiring corporation held by members of the EAG. This rule is not intuitive because Congress intended it to accomplish two opposite objectives. First, it intended the "affiliate disregard rule" to ensure that Code Sec. 7874 did apply to an inversion transaction where outstanding hook stock otherwise would cause the ownership condition not to be met. For example, U.S. parent shareholders would receive only 59 percent of the outstanding foreign stock, with the former U.S. parent holding the other 41 percent as hook stock after a reverse subsidiary merger. Second, it intended the rule to ensure that Code Sec. 7874 did not apply to internal group restructurings when nothing really escaped the U.S. tax net, either because the acquired domestic properties continue to be held indirectly by the same U.S. parent or because the parent was already foreign.

More recent guidance plugged other perceived loopholes. For example, the term "by reason of" means not only stock received in exchange for stock of a domestic corporation, but also stock received with respect to such stock, such as in a spinoff. The IRS and Treasury were concerned that taxpayers would use the internal group restructuring exception to package a foreign controlled corporation, which could then be spun to the public. Further, where a foreign corporation acquires multiple domestic corporations as part of a plan, they are treated as one domestic corporation (even if they are unrelated corporations) to ensure that no set of U.S. target owners can take the position that they received only a proportionate amount (that is, less than 60 percent) of the foreign acquiring corporation's stock by reason of their ownership in the domestic corporation.

3. Third Condition: Substantial Business Activities

Code Sec. 7874 does not define "substantial business activities." Temporary and proposed regulations published in 2006 provided both a facts and circumstances test and a safe harbor to determine whether this condition was satisfied. Five examples illustrated the application of the facts and circumstances test. If you practice international tax and did not know that the IRS and Treasury removed this safe harbor and these examples in 2009, then where have you been?

The preamble to the 2009 regulations explains that the IRS and Treasury decided to withdraw the safe harbor because of concern that it could apply to transactions inconsistent with Code Sec. 7874's purpose. The government apparently was concerned with fact patterns where a U.S. multinational has 90 percent of its activities in the United States and the remaining 10 percent concentrated in a single, low-tax jurisdiction. That concern, however, is misplaced as nearly all U.S. multinationals operate in a number of non-U.S. jurisdictions, not just one. Further, those who have actually attempted to apply the safe harbor to live fact patterns know that it is a rigorous standard and not one that is easily satisfied.

An EAG met the old safe harbor if at least 10 percent of its "group employees," "group assets," and "group sales" were located in the relevant country after the acquisition. The safe harbor was a rigorous standard because it defined these terms narrowly. For example, "group assets" included only tangible property. Both then and today, one prong of the more general "facts and circumstances test" that prevailed until June 2012, also focuses generally on employees, assets and sales, without defining those terms. For example, "assets" could include intangible property for purposes of the "operational activities" factor of the old facts and circumstances test (known today as the "conduct of continuous business activities" factor).

Many in the tax community criticized the removal of the safe harbor in 2009. In some ways, however, prior to its elimination in 2012, the facts and circumstances test that prevailed after the 2009 change, was more liberal than the prior version in several respects. For example, the prior test included "sales to customers in the foreign country," whereas the modified test generally referred to "sales to customers" and did not specify where the customers had to be located. Further, the preamble to the 2009 regulations provided that sales between EAG members may count as "sales to customers."

Other than these slight liberalizations, the regulations following the repeal of the safe harbor enumerated virtually identical factors to consider in determining whether an EAG has substantial business activities:

(1) historical conduct of business activities in the foreign country;
(2) operational activities involving the sub-factors discussed above (assets, performance of services by employees and sales);
(3) managerial activities by officers and employees in the foreign country;
(4) ownership of the EAG by investors resident in the foreign country; and
(5) business activities in the foreign country that are material to achieving overall business objectives.

In sum, after the removal of the safe harbor and the examples that illustrated the facts and circumstances test, taxpayers were left with the facts and circumstances test and the knowledge that Congress enacted Code Sec. 7874 to stop an inversion transaction resulting in a "minimal presence" in a foreign country. Taxpayers might also look to the "substantiality" element of limitation on benefit articles in tax treaties. Various treaties have limitations on benefits articles that can be satisfied where a resident from one contracting state conducts a business that is "substantial" in relation to the activity in the other contracting state. Safe harbors are sometimes provided that require an average of 10 percent of asset value, gross income and payroll expense be located in the resident state. Indeed, these somewhat analogous authorities informed the NYSBA Tax Section's initial recommendation that Treasury regulations provide a safe harbor based on a 7.5-percent figure.

Of course, other than with respect to an audit of a migration completed prior to June 7, 2012, the facts and circumstances test, like the safe harbor, is now a thing of the past. Instead, the new SBA test is like the old safe harbor on steroids with a massively bulked up 25-percent threshold substituted for the 10-percent threshold (and some related changes) and this 'roid raging rule as the *only* way to satisfy the SBA test.

III. Discussion of Key Recent Developments

There have been some very interesting developments in the relevant guidance under Code Secs. 367 and 7874 in the last several years—some of which has been newly issued guidance and some of which was issued previously, but has taken on increased prominence (*e.g.,* Notice 2009-78)[23] as a result of increased tax community focus on a wider range of potential transactions. There have also been a number of developments in related areas.[24] For present purposes, the key relevant developments addressed here that have been enacted are (1) the 25-percent threshold enacted in 2012 for the SBA test of Code Sec. 7874 mentioned above, (2) a 2011 coordination rule for the Code Sec. 367(a) shareholder level tax and the Code Sec. 367(b) "Killer B" regulations, (3) the increased focus on Notice 2009-78 and on T.D. 9654, which enacted and expanded that notice. The President's recent budget proposal would clearly have a substantial impact in this area (for example, the foreign partner would have to be larger than the domestic partner). It is unclear at this point, however, when or if this proposal would ever be enacted.

A. The New SBA Threshold

As indicated above, the SBA test under the Code Sec. 7874 regulations has had an ongoing series of changes and modifications. First, the regulations included (consisted with a NYS Bar Report), a facts and circumstances test combined with a 10-percent safe harbor. These regulations were issued in 2006. Then, in 2009, Treasury and the IRS eliminated the 10-percent safe harbor from the regulations—the concern apparently that a company could have 10 percent of its business in say Ireland and the other 90 percent in the United States and utilize the safe harbor to migrate to Ireland. Not a scenario we have seen much, but that was apparently the thinking. Finally, the most recent change to the SBA test was made in June 2012.

The new regulation test is found in Temporary Reg. §1.7874-3T. As indicated before, it eliminates the facts and circumstances test and adopts instead a single "bright line" rule of at least 25 percent of the relevant items and assets being located in the country in which the new foreign parent is incorporated.[25] The preamble justifies the new SBA rule as arising out of "requests" for "additional" guidance from the tax community.[26] It concludes by stating that "the IRS and the Treasury believe that such a [bright line] rule will provide more certainty in applying Code Sec. 7874 to particular transactions than the 2009 temporary regulations and will improve the administrability of this provision."[27] Just imagine how much more certainty and administrability would have been achieved with a 75-percent test or a 95-percent test!?!

This new SBA threshold requires that at least 25 percent of the employees and 25 percent of the employee compensation to be located in or attributable to the new foreign parent's country.[28] It also requires that at least 25 percent of the value of the group assets be located in that country.[29] For this purpose, "group assets" include only tangible personal or real property physically located in this country—it does not include intangible property.[30] Finally, it requires that at least 25 percent of the total group income be derived in the relevant country.[31] This rule is particularly restrictive as it applies only to a "transaction with a customer located in such country."[32] Thus, for example, the term generally does not apply to sales to related parties.

The new SBA test generally applies to relevant acquisitions by foreign corporations completed on or after June 7, 2012.[33] However, transition relief was provided for acquisitions on or after that date that were (1) described in a filing with the Securities Exchange Commission on or before June 7, 2012, or were (2) subject to a written agreement that was binding on or before that date.[34] If the transition rule were applicable, the taxpayer could apply either the new SBA test or the former facts and circumstances test.[35]

This new SBA test was met by fairly harsh criticism from the tax community. Most tax professionals (including the authors) would not deny the fact that Treasury and the IRS have the right to regulate in this area and, in fact, have some latitude in doing so. That said, there is not much question that Congress in enacting Code Sec. 7874 clearly intended that some corporations would be able to satisfy the SBA test given the way the statute is drafted. There also is not too much debate that at some threshold level

Treasury and the IRS would clearly be overreaching and effectively writing the SBA test out of the statute. If, for example, they had selected a "brightline" rule of 99 percent of assets, employees and income, everyone (we hope) would conclude they had overstepped their bounds. The issue then is whether 25 percent is a point too far and undermines the integrity of the statute. Reasonable people can disagree on this point, but it is fair to say that it is now *very* difficult to satisfy the new "clarified and more administrable" SBA test in most cases.

Moreover, it was also pretty clear that Treasury and the IRS were interested in hearing about any examples where the threshold was satisfied. In fact, they were reported to have been comforted to some extent by the *Liberty Global-Virgin Media* combination (discussed below) where the 25-percent threshold actually was satisfied because Virgin Media was almost exclusively operated out of the United Kingdom. That case likely illustrates one type of corporation that could satisfy the 25-percent threshold—a U.S.-headed corporation that was for example spun off in a prior Code Sec. 355 transaction where its operations are entirely or almost entirely foreign.[36] And, even then, the operations have to be heavily concentrated in one country (as they were for Tim Hortons or Virgin Media). That situation aside, unless the rule is modified, the SBA test will almost never be satisfied and is for most practical purposes a statutory nullity. This fact has led to more focus on the continuity requirements of Code Sec. 7874 (the 60-percent and 80-percent thresholds) and, as discussed below, a greater emphasis on combination transactions, where the SBA test really becomes irrelevant.

B. The Code Sec. 367(a) and (b) Coordination Rule

As discussed above, Code Sec. 367(a) and Reg. §1.367(a)-3(c) provide for potential taxation at the U.S. shareholder level on certain transfers of stock of domestic corporations to foreign corporations in otherwise nontaxable stock-for-stock exchanges. This tax treatment (the "Code Sec. 367(a) Income Recognition") was intended in large part as a means of inhibiting a domestic corporation's ability or willingness to self migrate. It is clear, however, that these rules also apply to combination migration transactions.

The Code Sec. 367(b) regulations provide particular rules that can result for certain transactions, so-called "Killer B" triangular reorganizations, in taxable deemed distribution treatment (the "Code Sec. 367(b) Income Recognition").[37] The potential overlap between the Code Sec. 367(a) Income Recognition and the Code Sec. 367(b) Income Recognition caused Treasury and the IRS to insert a "coordination rule" in a 2011 regulation package to referee application of the two rules.[38] The basic result is that if both provisions apply, the one resulting in the greater gain controls and the other is turned off.[39]

It may be helpful to provide a brief background on these so-called Killer B transactions.[40] A Killer B transaction is a transaction that was very popular in the early to mid 2000s. In the classic (simplified) example, U.S.P is a publicly traded U.S. parent corporation. It owns U.S. Sub and FA, a CFC with significant cash and E & P. U.S. Sub, in turn, owns one or more Foreign Subs (also CFCs). FA purchases voting stock of its parent, U.S.P, in exchange for cash and/or notes. FA then uses that voting stock to acquire one or more Foreign Subs from U.S. Sub, which retains the U.S.P voting stock. The acquisition is treated as a triangular B reorganization pursuant to Code Sec. 368(a)(1)(B) (or as a triangular C reorganization if check-the-box elections are made on the Foreign Subs).

The key to the transaction, however, was the parties ability to rely, based on prevailing rules under Code Sec. 1032 and otherwise, on the purchase of U.S.P stock by FA from U.S.P being nontaxable to U.S.P pursuant to Code Sec. 1032. This type of transaction also had an "outbound" aspect where a U.S. subsidiary would purchase voting stock of its foreign parent for similar use in a triangular reorganization (thus, avoiding any U.S. withholding tax as a result of the application of Code Sec. 1032). In either scenario, it was generally accepted that Code Sec. 1032 applied and that the relevant "payment" could not be characterized under general principles as a separate distribution from FA (or the U.S. subsidiary) to U.S.P (or the foreign parent). In fact, it appears that the IRS has had relatively little success challenging these transactions in audit using general principles (at least where there was a good reorganization).

Treasury and the IRS eventually responded to what had become a mass-marketed repatriation technique by issuing Notice 2006-85.[41] This notice provided, among other things, that in relevant triangular reorganizations, like the classic example described above, the payment by FA of cash and/or notes to U.S.P for U.S.P voting stock was in effect treated as a separate distribution subject to Code Sec. 301 from FA to U.S.P. This conclusion was premised on the belief that Code Sec. 367 generally provided Treasury and the IRS with broad authority to deal with various cross-border transactions, particularly in a high profile area like repatriation. Thus, the notice provided a specific rule that created a separate distribution, which was more difficult to invoke under general principles. The notice also applied the same rule to outbound transactions where a U.S. subsidiary purchases stock of its foreign parent, although some in the tax community questioned whether there was sufficient authority to do that.

Notice 2006-85 left open situations where, for example, FA acquires U.S.P voting stock not from U.S.P directly, but rather on the open market. This transaction was more difficult to structure and certainly harder to mass market. Nonetheless, taxpayers begin to implement these "open market" transactions. In response, Treasury and the IRS issued Notice 2007-48.[42] This notice applied a similar deemed distribution concept to Killer B transactions involving open market purchases and similar transactions. It creates a separate distribution subject to Code Sec. 301 from, *e.g.,* FA to U.S.P in an amount equal to what FA paid for the U.S.P stock in the open market. The notice also provides that the amount deemed distributed by FA to U.S.P is considered immediately thereafter to have been contributed by U.S.P back to FA, thereby increasing U.S.P's basis in FA. This notice applied to transactions occurring on or after May 31, 2007, and again applied to stock purchases in these settings both inbound and outbound.

The Treasury and the IRS promulgated Killer B regulations applicable to all transactions covered by the Notices in 2008.[43] These 2008 Temporary regulations were removed when final regulations were issued in 2011.[44] The final regulations include the basic mechanics of the Notices, that is a separate distribution subject to Code Sec. 301 from the acquiring subsidiary to the relevant parent corporation (foreign or domestic). They also include the "deemed contribution" rule of Notice 2007-48 applicable to all covered triangular reorganizations (whether the voting stock is purchased directly from the parent corporation on the open market).[45] This rule results in a stepped up basis in the stock of, *e.g.,* FA. The final regulations also include a somewhat vague "anti-abuse" rule that requires "appropriate adjustments" if in connection with a covered triangular reorganization, a transaction is engaged in with a view to avoid the purposes of the Killer B regulations.[46] The only example provided of this type of "abuse" is the funding of a corporation without E & P by a related corporation that has E & P with the former corporation making the critical parent stock purchase.[47] This rule is similar in some ways to the so-called "conduit" rule of Code Sec. 956.[48]

As indicated above, T.D. 9526 also included a coordination rule for Code Sec. 367(a) Income Recognition and Code Sec. 367(b) Income Recognition. These rules are found in Reg. §1.367(b)-10(a)(2)(iii) and Reg. §1.367(a)-3(a)(2)(iv). The Code Sec. 367(b) rule provides that if the Code Sec. 367(a) Income Recognition is equal to or greater than the amount of Code Sec. 367(b) Income Recognition, then the Killer B regulations are turned off.[49] The comparison generally focuses on the Code Sec. 367(a) shareholder gain, on the one hand, and the sum of the amount treated as a dividend under Code Sec. 301(c)(1) and the amount treated as gain under Code Sec. 301(c)(3),[50] on the other hand. The companion rule turns off the Code Sec. 367(a) rules if the amount of the gain otherwise recognized under Code Sec. 367(a) is *less than* the 301(c)(1) dividend and Code Sec. 301(c)(3) gain pursuant to the Killer B regulations.[51] Thus, a "tie" goes to Code Sec. 367(a) Income Recognition.

Our understanding is that this coordination rule was inserted into T.D. 9526 near the end of the process with the intention of being fair to taxpayers. The goal is to avoid taxpayers recognizing both shareholder level gain *and* corporate level deemed distributions. Because the coordination rule has an "either/or" aspect, it means in appropriate circumstances that either the shareholder level tax or the Killer B deemed distribution rule may apply, but not both. Taxpayers are definitely considering when application of the coordination rule turns off Code Sec. 367(a) shareholder level tax in appropriate cases, despite complexities in determining, *e.g.,* the amount of shareholder gain at stake. However, consideration is often given to circumstances where application of the coordination rule turns off the deemed distribution result for Killer B type transactions (allowing Code Sec. 1032 to apply again), in favor of the Code Sec. 367(a) shareholder level tax. The coordination rule will be discussed in Section IV of the paper on transactional trendlines.

C. T.D. 9654 and the Increased Focus on Notice 2009-78

Notice 2009-78 had become more of a focal point since its issuance on October 5, 2009, as taxpayers have explored whether a range of transactions satisfy Code Sec. 7874. On January 16, 2014, the IRS released final and temporary regulations under Code Sec. 7874 which generally did not go far afield of the Notice. The rules help resolve some of the uncertainty regarding the scope of the "disqualified stock" rules that taxpayers have been confronting since the release of the Notice. For example, rather than a combination transaction with a foreign publicly traded corporation, consideration has been given to a combination between a public U.S. multinational and a wholly or partly owned foreign subsidiary of either a U.S. or foreign parent company. In these settings, consideration of Notice 2009-78 has been common place,[52] and such combinations generally can be structured in appropriate circumstances to avoid some or all of the adverse consequences of Code Sec. 7874 under the new regulations.

A key reason behind the issuance of Notice 2009-78 was the seemingly restrictive nature of Code Sec. 7874(c)(2)(B). Code Sec. 7874(c)(2) generally provides rules for disregarded certain stock for purposes of applying the 60-percent (or 80-percent) continuity tests. Included in this exclusion is stock of the new foreign parent "sold in a *public* offering" that is related to the acquisition of a domestic corporation.[53] Thus, taxpayers are not able to lower the continuity of the shareholders of the domestic corporation in question for purposes of whether Code Sec. 7874 applies by counting stock issued to third parties by the new foreign parent in a related public offering. The Notice extended this rule to private offerings for "nonqualified property" (*e.g.,* cash). The recent regulations basically continue this part of the rule.

The regulations go beyond the Notice in applying its rules to stock of the foreign acquiring corporation without regard to whether such transfer of the stock occurs by reason of an issuance, sale, distribution, exchange or any other type of disposition.[54] Foreign acquiring stock may also be disqualified regardless of whether the stock is transferred by the foreign acquiring corporation or another person. Foreign acquiring stock is not disregarded, however, if it is transferred in a transaction that does not increase the net assets of the foreign acquiring corporation.[55] Thus, for example, transfers of foreign acquiring stock by one shareholder to another would not be treated as disqualified stock.[56]

Consistent with the Notice, the regulations aim to correct the over-inclusiveness of Code Sec. 7874(c)(2)'s public offering rule by providing that even if acquiror's stock is issued in a public offering, such stock is not treated as disqualified as long as it was not issued for nonqualified property (unless a principal purpose for its issuance was the avoidance of Code Sec. 7874).[57]

At its core, Notice 2009-78 changed the focus of the statute from *public* stock offerings to a wide range of offerings. This change by notice surprised some in the tax community by expanding the statutory rule to include disregarding stock issued by the new foreign parent in a *private* offering. This change is seen by some as inconsistent with the evidenced Congressional intent regarding *public* offerings.[58] This is especially true given that an earlier version of Code Sec. 7874 actually would have also disregarded stock issued in private offerings, but Congress ultimately limited the statute to public offerings.

Although it is not clear why publicly issued stock should be treated differently than privately issued stock, excluding the latter entirely may be too broad. The IRS and Treasury may have been asked to consider revising the rule described in Notice 2009-78. Otherwise, transactions that clearly look like cash purchases (rather than inversions with an accommodation transfer of cash) become inversions. For example, assume the management of a domestic corporation takes it private by cashing out the other shareholders, but the management also happens to exchange its options in the domestic target for options in the foreign acquiring corporation. Any stock in the foreign acquiring corporation that may have been issued for cash is excluded, and the only equity in the ownership fraction is the interest represented by the options, which are treated as stock to the extent they have a claim on equity.[59] Accordingly, under Notice 2009-78, an inversion occurs.

Under the regulations, however, a rather narrow *de minimis* exception could apply. The exception exempts from the category of disqualified stock foreign acquiring stock that is issued in a transaction where, absent application of the disqualified stock rules, the ownership fraction would be less than five percent.[60] This low threshold seems inconsistent with the statutory objective. Acquisitions with relatively little, but still greater than five-percent ownership continuity—in particular management roll-over transactions—more closely resemble cash purchases and would not appear to be the type of transactions targeted by Code Sec. 7874.

It is easy to understand why the IRS and Treasury reacted adversely to transactions in which a cash accommodation party could be used to skirt Code Sec. 7874. At the same time, it is hard to see how one ever thought such a transaction could avoid Code Sec. 7874, given that Code Sec. 7874(c)(4) automatically disregards contributions of property if a principal purpose of the transfer is to avoid the purposes of Code Sec. 7874. Ultimately, Notice 2009-78 and the regulations need in our view further work to define properly the distinction between acceptable cash purchases and transactions that inappropriately avoid Code Sec. 7874.

Notice 2009-78 makes clear that stock of the new foreign parent issued in a "related" transaction in exchange for "nonqualified property" is not taken into account for continuity purposes whether or not it was sold in a public offering.[61] For this purpose, nonqualified property generally includes (1) cash or cash equivalents, (2) "marketable securities" as defined in Code Sec. 453(f)(2), and (3) any other property acquired in a transaction with *a* principal purpose of avoiding the purposes of Code Sec. 7874. However, under both the Notice and the regulations, the term marketable securities for this purpose generally does not include stock of a corporation (*e.g.,* the foreign target in a combination transaction) that is a member of the EAG of the new foreign parent after the deal, unless a principal purpose was the avoidance of Code Sec. 7874.[62] As illustrated by Example 3 of the regulations,[63] the stock of the foreign target in a combination transaction should not violate the "principal purpose" provision where the foreign target becomes a member of the EAG of the new foreign parent (more than 50 percent owned by the new foreign parent), even if that stock previously was publicly traded.

The same should be true of a foreign target that is a nontraded foreign subsidiary of the transferor in a combination transaction. That stock by definition should not be a marketable security and so it also should not violate the principal purpose point. Thus, the regulations generally should permit the combination of a nontraded foreign subsidiary with a domestic corporation under a new foreign parent (especially when the former foreign subsidiary becomes a member of the new foreign parent's EAG). Query the result if, for example, the foreign property transferred in the combination transaction is say 40 percent of the stock of a traded or nontraded foreign corporation that would not be part of the EAG.

The regulations adopt the Notice's three categories of nonqualified property, but add a new, fourth category—"disqualified obligations"—which are obligations of (i) a member of the expanded affiliated group that includes the foreign acquiring corporation; (ii) a former shareholder or former partner of the domestic entity; or (iii) a person that, before or after the acquisition, either owns stock of, or a partnership interest in, any person described in (i) or (ii) or is related to any such persons.[64] The preamble to the regulations notes that these obligations present similar opportunities to inappropriately reduce the ownership fraction by increasing the net assets of the foreign acquiring corporation.

The regulations include a new "associated obligation rule" indicating that disqualified stock includes the foreign acquiror's stock transferred to any person in exchange for property that is not otherwise treated as nonqualified property to the extent that, pursuant to related transactions, the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of an obligation associated with the exchanged property.[65] Thus, for example, if a foreign acquiring corporation acquires business assets of a domestic corporation in exchange for foreign acquiring stock, and the domestic corporation uses a portion of the foreign acquiring stock to satisfy obligations associated with those assets, the stock used to satisfy such obligations will be disregarded.[66]

Given the regulations' definition of nonqualified property, the rules can yield different results depending on how a transaction is structured. Where a foreign acquiring corporation issues stock in consideration for the *stock* of a foreign target corporation, the stock will not be disqualified regardless of the asset composition of the foreign target corporation (provided the foreign target becomes a member of the foreign acquiring corporation's EAG and the "principal purpose" prong of the definition of nonqualified property does not apply). However, if instead the foreign acquiring corporation acquires *assets* of the foreign target in exchange for stock, any stock that is allocable to nonqualified property—*e.g.,* working capital—of the foreign target corporation is disqualified stock. The preamble notes that dissimilar treatment of such economically identical transactions may be questionable, but the IRS and Treasury rejected as too complex rules that would have harmonized the treatment of stock and asset acquisitions. From a policy perspective, however, it is not clear that disparate treatment of otherwise economically identical stock and asset acquisitions is consistent with the purposes of Code Sec. 7874.

The IRS may have felt it was locked into the existing scope of Notice 2009-78 especially in light of several high profile bankruptcy transactions that the IRS believed were or should be subject to the inversion rules. It is quite possible that this is why now, almost four years after the notice was issued, the regulations continue to utilize the 2009 effective date for which Notice 2009-78 put a stake in the ground. The rules described in the Notice and set forth in the temporary regulations apply to acquisitions completed on or after September 17, 2009.[67] No exception is included for transactions completed on or after that date but pursuant to a binding commitment entered into before such date. Those aspects of the regulations that go beyond the rules described in the Notice—for example the inclusion of "disqualified obligations" as a fourth category of nonqualified property—only apply to acquisitions completed on or after January 16, 2014.[68]

The Treasury Regulations provide that, when a domestic corporation is in bankruptcy or is insolvent, each creditor can be treated as a shareholder for all purposes of Code Sec. 7874.[69] There is other authority for this provision.[70] Notice 2009-78, and the regulations thereunder, makes this creditor/shareholder rule even more noteworthy. An important consideration will be whether creditors receive an equity interest in the new foreign parent by reason of their claims against the insolvent domestic corporation.

IV. Selected Transactional Developments

In this section, the paper highlights certain key transactional trends and developments. There are clearly other areas that could and should be considered, but we have to put the readers out of their misery sometime! As a result, this paper limits the transactional developments to three key areas. First, it discusses what if anything is left of the so-called "self " or "internal" migrations after the adoption of the 25-percent SBA test in June 2012 and briefly discusses one—the Sara Lee restructuring—that straddled the enactment of that new test. Second, it discusses situations where the parties try to avoid the Code Sec. 367(a) shareholder level tax, despite the fact that in many cases this tax is not an obstacle to a transaction. In particular, it discusses (1) "skinny down" dividends and (2) affirmative use of the Code Sec. 367(a) and (b) coordination rule discussed above. Finally, this section of the paper addresses the most recent trend or "wave"—combination transactions where the new SBA test cannot be satisfied, but the continuity thresholds (60 percent or 80 percent) can be the ticket out of all or much of Code Sec. 7874.

A. Self Migration Transactions

As discussed above, in June 2012, Treasury and the IRS adopted a single rule for the SBA test that makes it virtually impossible in most cases for a U.S. corporation to do a "self " migration. Some could argue—as the IRS undoubtedly does—that this is not a bad outcome from a tax policy perspective. Regardless of one's views on that, it seems safe to say that Congress at least did not contemplate (so far) the effective elimination of the SBA test as a way out of Code Sec. 7874. The statute clearly seems to contemplate that some of these transactions could, in fact, satisfy this test.

In any case, the number of self migrations has and certainly will decline sharply unless and until a change is made in that rule. In the period leading up to the promulgation of the new SBA test, there were at least three self migrations of note. There were the migrations of Aon, an insurance industry multinational, to the United Kingdom, and of Rowan, an oil drilling company also to the United Kingdom. And, of note for present purposes the restructuring and migration of the coffee business of Sara Lee. The Sara Lee migration in particular is noteworthy for several reasons—it involved a Code Sec. 355 spin off before the migration and it appears to have been a transaction that could qualify for the transition relief in Reg. §1.7874-3T(f).

Sara Lee was a U.S. multinational that at one time had numerous business lines (a true conglomerate). Over time, Sara Lee disposed of by sale or otherwise a number of its other business lines. By 2010 or so it had two principal businesses—a meats business largely located in the United States (Hillshire Farms, *etc.*) and a coffee and tea business headquartered in the Netherlands (Dowe Egberts). The coffee business was acquired by Sara Lee in the late 1970's and over the next 30-plus years remained a fairly independent business operation.

The business decision was made to split Sara Lee into two "pure play" companies—one focused on the meats business and the other focused on the coffee business. This provided the strong business purpose needed to support the separation transaction as a Code Sec. 355 spin off (actually a spin off as part of an overall D reorganization). The intention in connection with this split up was to consider a possible migration of the coffee business to the Netherlands.

For a variety of reasons it was decided that the coffee business would be distributed to the public.

The transaction was enormously complex. But, in basic terms it involved the transfer by Sara Lee of the top Dutch CFC heading the coffee business to a new U.S. subsidiary (U.S. Spinco), followed by the *pro rata* distribution of U.S. Spinco to the Sara Lee shareholders. It was necessary to use a U.S. spinco to hold the foreign coffee business in order to avoid substantial corporate level tax under the Code Sec. 367 rules.[71] In connection with the distribution of U.S. Spinco, a Dutch subsidiary of U.S. Spinco was formed (New Dutch Parent) and it in turn formed a U.S. Merger Sub. The U.S. Merger Sub merged with and into U.S. Spinco, with U.S. Spinco surviving. The state law merger resulted in U.S. Spinco becoming a subsidiary of New Dutch Parent and the Sara Lee shareholders exchanging their U.S. Spinco stock for New Dutch Parent, which became a publicly traded company.

The migration transaction qualified as a reverse triangular merger (and possibly also as a B reorganization).[72] The exchange was taxable to the U.S. shareholders of U.S. Spinco under the Code Sec. 367(a) rules discussed above.[73] Specifically, the transaction failed the 50 percent of Reg. §1.367(a)-3(c) because all the shareholders of U.S. Spinco basically became shareholders of New Dutch Parent. As a result, those shareholders recognized gain, but not loss, on the exchange (another example of the Code Sec. 367(a) tax not being an obstacle to a migration).

The key issue for present purposes is the application of Code Sec. 7874 to New Dutch Parent. The continuity thresholds were clearly passed. Thus, the application of Code Sec. 7874 generally turned on the result under the SBA test. The parties determined that the new 25-percent test was not applicable to New Dutch Parent because the transaction had been reflected in an SEC filing prior to the effective date.[74] That said, it is possible that the New Dutch Parent could have satisfied the 25-percent test.

Under the facts and circumstances test prevailing at the time, New Dutch Parent had a very strong case. The coffee business had been started in the Netherlands in *1753*! So there was a 260 year history of business activity in the Netherlands. Moreover, the coffee business had largely been run out of the Netherlands, even after Sara Lee acquired it. And, the Netherlands was clearly the operational and strategic centerpiece of this business.

One last point to note. Under the new "bright line" 25-percent SBA test, all of the points just mentioned are irrelevant. In particular, a 260 year operating history in the Netherlands is not a factor in the analysis. One has to wonder about the reasonableness of a rule where strong factors like this are entirely irrelevant to the analysis.

B. Ensuring Nonrecognition Treatment Under the Code Sec. 367(a) Rules

There is no question that most migrations since the mid-1990's have involved a shareholder level tax on the exchange pursuant to Reg. §1.367(a)-3(c). There is no way in self-migration situations to avoid the 50-percent continuity rule of Code Sec. 367(a). This is also true for many of the combination migrations as well. The fact is that in these situations the shareholder level tax has not proven to be a sufficient obstacle to completing the deal. There are a number of reasons for this. Many companies have large shareholder bases that either are tax exempt (pension funds) or tax indifferent (for example, shareholders subject to annual mark-to-market treatment). In addition, depending on the prevailing market conditions many shareholders have relatively low built-in gain in their stock. Finally, the benefits of migrating are often substantial enough that companies are able to "cram down" the migration.

There are, however, situations where the Code Sec. 367(a) tax is in fact a real obstacle—for example cases involving significant founding shareholders. In those cases, there are certain planning options that might be used to avoid the application of Reg. §1.367(a)-3(c). Two of these techniques are discussed below. The first is the so-called "skinny down" dividend of the U.S. corporation in a combination transaction. The best known example of that is likely the Biovail/Valeant combination from 2010. The second is the application of the coordination rule discussed above in circumstances where the Code Sec. 367(a) shareholder level tax is turned off in favor of a deemed "Killer B" distribution under Reg. §1.367(b)-10. The best known example of this is the Liberty Global/Virgin Media combination.

1. The Skinny Down Dividend

As mentioned above, a key example of the use of a skinny down dividend to avoid the shareholder level tax occurred in the combination of Biovail and Valeant in 2010. This combination predates the current "wave" involving combination migrations, but is also illustrative of those types of transactions (discussed in more detail below).

Biovail was a publicly traded Canadian corporation engaged in the pharmaceutical business. Valeant was a publicly traded U.S. corporation also engaged in the pharmaceutical business. There were strong business synergies for a combination of the two companies. Valeant was historically the larger of the two companies. On a pro form basis Valeant would have constituted somewhere around 58 percent of the combined value. Valeant was in every real sense the acquiring company—its name was retained, and its management largely took control of the combined companies.

The size difference would have raised no particular issues if Valeant had actually acquired Biovail. However, there were substantial non-U.S. reasons for Biovail to be the notional acquiring corporation. A stock-for-stock exchange was envisioned. As a result, without further planning the exchange would have been taxable to the Valeant U.S. shareholders under Reg. §1.367(a)-3(c) (the 50-percent threshold would clearly have been crossed). This was a transaction in which the shareholder level tax was problematic.

To ensure nonrecognition treatment given the Code Sec. 367(a) rules, the parties decided to have Valeant pay a pre-transaction "Special Dividend" on a *pro rata* basis to the Valeant shareholders. This substantial distribution was funded from available assets of Valeant and additional borrowings of the company, which Valeant could service on a standalone basis. The intention of the dividend was to reduce the pre-transaction value of Valeant below 50 percent prior to the combination. The dividend was paid the day before the acquisition. The Special Dividend meant that the Valeant shareholders as a group received less than 50 percent of the stock of Biovail. Thus, the 50-percent thresholds were not crossed (the second 50-percent threshold for "insiders," *etc.,* was also not crossed). Moreover, the "substantiality" test (relative size of each corporation) was also satisfied.

The Code Sec. 367(a) rules have specific rules relating to "stuffing" transactions undertaken to increase the size of the relevant foreign corporation.[75] However, these rules have nothing specific on stripping transactions designed to make the U.S. corporation smaller. This is in contrast to Code Sec. 7874, which was enacted subsequently, that addresses both stuffing and stripping transactions.[76] As a result, the belief was that, properly structured, the Special Dividend would adequately reduce the size of Valeant so that the transaction would remain nontaxable under the Code Sec. 367(a) rules (the exchange was otherwise a nontaxable reorganization to the Valeant shareholders). The key in these cases is to make sure that the U.S. corporation involved is able to fully fund the skinny down dividend on its own without relying on the foreign corporation to replenish those assets or service any financing debt. The actual process of determining the proper size of the skinny down dividend is extremely complex given, among other things, fluctuating stock values, options, *etc.*

The IRS seems to agree that, if properly done, a skinny down dividend of the U.S. corporation can avoid application of Reg. §1.367(a)-3(c). Informal conversions with the IRS confirmed this. That said, the IRS has consistently refused to rule on this issue—perhaps worried about creating a slippery slope or encouraging a flood of similar requests. So, this is an issue that has to be supported by an opinion.

The Code Sec. 7874 rules also have to be considered. As indicated above, Code Sec. 7874 can apply to disregard both distributions and contributions if they are part of a plan, a principal purpose of which is to avoid Code Sec. 7874.[77] In the Biovail/Valeant combination, even if the Special Dividend were somehow added back in and treated as "stock" for continuity purposes, the Valeant shareholders would only have received, say, 58 percent of the combined company. As a result, the 80-percent threshold would clearly not have been met to treat Biovail as a domestic corporation, and even the attribute limitation rule applicable to the 60-percent threshold would not have been met.

2. The Code Sec. 367(a) and (b) Coordination Rule

The "skinny down" dividend of the U.S. corporation is one way (albeit with complexities) to preserve nonrecognition treatment under the Code Sec. 367(a) rules. Another way as indicated above is the application of the coordination rule between Reg. §1.367(a)-3(c) and the Killer B rules of Reg. §1.367(b)-10. In this context, the overlap basically would arise where a New Foreign Parent is used to acquire a U.S. corporation and, typically, a foreign corporation in something akin to a "double dummy" structure with the U.S. side qualifying as a triangular reorganization.

The transaction would be subject to Reg. §1.367(a)-3(c) if the U.S. corporation is larger than the foreign corporation. However, if the U.S. corporation, or its U.S. acquiring parent acquires voting stock of the New Foreign Parent for cash and/or a note, the Killer B regulations of Reg. §1.367(b)-10 are also implicated. Under the coordination rule, if the Code Sec. 301(c)(1) income and the Code Sec. 301(c)(3) gain to the New Foreign Parent in the aggregate are greater than the shareholder level gain under Code Sec. 367(a), then the Killer B regulations control and the Code Sec. 367(a) shareholder level tax is turned off.[78] This analysis is extremely complex, particularly determining the potential Code Sec. 367(a) gain, given the diversity of shareholder profiles and ongoing stock price fluctuations.

This was the situation presented in connection with the combination transaction between Liberty Global and Virgin Media. Like Biovail/Valeant, this transaction is also representative of the current trend to combination migrations (discussed in the next section). Interestingly, this transaction involved the combination of two U.S. multinationals under a new foreign parent, though each was largely foreign from an operational standpoint. Both Liberty Global and Virgin Media were the product of prior restructurings that occurred years before in which U.S. headed groups with largely foreign operations became public companies. Virgin Media, in particular, was virtually entirely U.K. from a structural and operational standpoint (it was actually a company that could have satisfied the new 25-percent SBA test on a self inversion to the United Kingdom). Liberty Global and Virgin Media are global media companies.

In the transaction, Liberty Global and Virgin Media combined under a new U.K. Parent using a complex structure that results in a triangular reorganization of the Liberty Global side. The Liberty Global shareholders ended up with about 55 percent of the New UK Parent stock and the Virgin Media shareholders ended up with about 45 percent of that stock. As reported publicly, the Liberty Global side of the combination was completed via a large Killer B transaction as part of a triangular reorganization where a U.S. acquiring corporation purchased substantial voting stock from its parent, New U.K. Parent, for use in the transaction.

The transaction raises issues under Code Sec. 367(a) and Code Sec. 7874. Taking the Code Sec. 7874 issues first, for purposes of the continuity tests, Liberty Global and Virgin Media are not analyzed separately. Rather, the Code Sec. 7874 rules treat the related acquisitions by a foreign corporation (here New U.K. Parent) of more than one domestic corporation as, in effect, the acquisition of a single domestic corporation.[79] Thus, the continuity test probably is applied to the aggregate of the Liberty Global and Virgin Media former shareholders. If so, the 80-percent continuity threshold may be passed because together those former shareholder own more than 80 percent of New U.K. Parent. However, Virgin Media's operations are so predominantly U.K. oriented (and Liberty Global also has significant U.K. operations) that in any event the transaction satisfied even the more stringent 25-percent SBA test (the part of this transaction that the IRS apparently likes).[80] As a result, the New U.K. Parent is respected as a foreign corporation for U.K. tax purposes.

On the Code Sec. 367 side, there is not a similar "aggregation" rule like Reg. §1.7874-2(e). The Virgin Media U.S. shareholders are not subject to Code Sec. 367(a) taxation because (1) they received less than 50 percent of New U.K. Parent as a group and (2) New U.K. Parent (including Liberty Global) is larger than Virgin Media and so the substantiality test would be satisfied.[81] On the Liberty global side, those shareholders received in the aggregate more than 50 percent of the stock of New U.K. Parent. However, the Killer B deemed distribution (not including Code Sec. 301(c)(2) basis recovery) was reported to exceed the relevant Code Sec. 367(a) gain to the Liberty Global U.S. shareholders. As a result, under the coordination rule the Killer B rules take priority over the Code Sec. 367(a) shareholder level tax. It is hard to see the anti-abuse rule applying given that the transaction was fully subject to the Killer B regulations.[82]

This is a complicated structure to implement though it was done successfully here. It is worth noting that, as mentioned before, while the coordination rule can apply to turn off Code Sec. 367(a), we are also seeing a number of instances where the rule operates to turn off the Killer B regulations in favor of the Code Sec. 367(a) tax.

C. Combination Transactions and the Continuity Thresholds

As indicated previously, there are two principal ways to avoid the harshest aspects of Code Sec. 7874 (treatment of the new foreign parent as a domestic corporation). One way is to satisfy the SBA test based on the location of the combined businesses in the country in which the new foreign parent is incorporated. The other is to avoid satisfying either of the continuity tests of Code Sec. 7874—in particular, the 80-percent threshold. Treasury and the IRS have made satisfying the new SBA test in the self-migration (or combination migration setting) context virtually impossible to satisfy (except in the Tim Hortons or Virgin Media type fact pattern). As a result, taxpayers have paid greater attention to the continuity threshold test.

This has caused investment bankers, Big 4 and other advisors to focus increasingly on combination transactions, typically of a U.S. corporation and a smaller foreign corporation. If the foreign corporation is more than 25 percent the size of the U.S. corporation, then its shareholders would receive more than 20 percent of the stock of the new foreign parent. In that case, the

80-percent threshold would not be satisfied and the new foreign parent would be respected as a foreign corporation for U.S. federal income tax purposes. As a result, the SBA test in effect is not relevant (Code Sec. 7874 works on a "disjunctive" basis—out of any requirement, and one is out of the statute; Reg. §1.367(a)-3(c) works on a "conjunctive" basis—need to be out of all the requirements to be out of the statute). The 60-percent threshold and the attribute limitation rules have tended not to be a significant obstacle in many cases. Also, the Code Sec. 367(a) shareholder level tax has not been an obstacle in many of these cases.

So, the perhaps overly harsh rules in the new 25-percent SBA test has resulted in more focus on combination transactions in which the 80-percent threshold of Code Sec. 7874 is not satisfied (and the SBA test is not critical), and the foreign corporate status of the new foreign parent is preserved. In addition to the Biovail/Valeant and Liberty Global/Virgin Media combinations previously discussed, other recent examples of these combination transactions include Actavis/Warner, Applied Materials/Tokyo Electron, Elan/Perrigo and Omnicom/Publicis (the latter apparently involving a skinny down dividend). Interesting, even though the continuity test places these transactions outside of Code Sec. 7874 altogether, the jurisdiction for the new foreign parents have not been the type of tax havens used in the past (Bermuda, Bahamas, Cayman Island, *etc.*). Instead, this new wave of combination migrations has followed the pattern of previously inverted U.S. companies that migrated from a pure tax haven to a more mainstream jurisdiction like Ireland or Switzerland (Tyco, Foster Wheeler, Transocean, Covidien, Ingersoll Rand, *etc.*). The most frequent choices for new foreign parent location have been the U.K., Ireland, Switzerland and the Netherlands.

In this context, the paper briefly discusses another representative combination transaction—Eaton/Cooper Industries. This transaction like others of its type are *business* combinations—business synergies typically drive the transaction. Although the actual transaction was highly complex, the paper will simplify it for illustration purposes. Eaton was a U.S.-headed multinational engaged in a range of industrial activities. Cooper Industries was a similar corporation, but was headed by an Irish parent. Cooper Industries had previously been a U.S. corporation that did a self inversion to a tax haven in the days before Code Sec. 7874. It subsequently redomiciled, as had many other inverted companies, to Ireland. The business synergies for the combination were strong.

The parties created a New Irish Parent, and using a version of a double dummy type of structure, the New Irish Parent company acquired Eaton and Cooper Ireland. The Eaton shareholders received about 73 percent of the stock of the New Irish Parent and the Cooper shareholders received about 27 percent of that stock (plus cash). The transaction was taxable to the Eaton U.S. shareholders under Code Sec. 367(a) and Reg. §1.367(a)-3(c). There was no skinny down dividend or use of the coordination rule. The Cooper U.S. shareholders were not taxed, among other reasons, because Cooper was already a foreign corporation.[83]

The transaction did not satisfy the SBA test even though there are meaningful operations in Ireland. However, because the Eaton shareholders only acquired 73 percent of the New Irish Parent, the 80-percent threshold was not passed and New Irish Parent is respected as a foreign corporation. The "multiple target" aggregate rule does not apply because Cooper is a foreign corporation.[84] The transaction did pass the 60-percent threshold of Code Sec. 7874 and so the parties are subject to certain attribute limitations. Nonetheless, this restriction was not an obstacle to the transaction. Combination migrations continue to be the current "wave" here, though many more transactions are not completed for business reasons than deals are actually done.

V. Additional Thoughts and Conclusions

The landscape continues to change in the cross-border migration area. For years, the government has struggled to prevent the self-migration transaction. Following Code Sec. 1248(i), Reg. §1.367(a)-3(c), Code Sec. 7874, several sets of Code Sec. 7874 regulations, Treasury and the IRS may have finally succeeded in most cases with the "bright line" 25-percent threshold rule for the SBA test. This overly restrictive rule has caused the tax community to look more closely at combination transactions for which the ownership continuity rules of Code Sec. 7874 are paramount. Here, Treasury and the IRS cannot as easily change this by a stroke of their regulatory pen. In this case, statutory change would be required (as indicated, such a bare bones proposal was recently included in the Administration's 2015 Budget). The question is whether and when any such change might be made. Cross-border combination transactions of this type are difficult to structure and conclude and, while many are considered, relatively few actually are completed.

These combinations are real deals in which business considerations drive the transactions, and tax is considered only if the transaction otherwise makes business sense. As a result, they are harder for the government to complain about or contest. In any event, the landscape continues to evolve in the cross-border migration area, and it will be interesting to see what the next chapter will be.

ENDNOTES

1 The Administration FY 2015 Budget Proposals included potentially significant changes to Code Sec. 7874. *See* "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals." *See also* Letter of Senator Grassley to Treasury (March 12, 2014) (noting potential absurd results of Administration proposal and need to complete Treasury study). Another set of Code Sec. 7874 regulations was just issued in January 2014. *See* T.D. 9654, 79 FR 12 (Jan. 17, 2014).

2 This history is described in Ensco's home page. *See www.enscoplc.com.* (About Us–History).

3 For an excellent and thoughtful discussion please *see* Steven M. Surdell, *Inversions 2014—Self Help International Tax Reform for U.S. Multinationals?,* 92 TAXES 3, March 2014.

4 This history is described in McDermott International's home page. *See www.mcdermott.com* (About Us–History).

5 The transaction was designed to fail the Code Sec. 351 requirements and thereby enable McDermott shareholders to recognize losses in their stock. *See R.K. Bhada*, CA-6, 90-1 USTC ¶50,001, 892 F2d 39.

6 Deficit Reduction Act of 1984 (P.L. 98-369), Act Sec. 133(a).

7 Notice 94-46, 1994-1 CB 356.

8 60 FR 66739 and 66771 (Dec. 26, 1995).

9 T.D. 8702, 1997-1 CB 92, 61 FR 68633-68641 (Dec. 30, 1996).

10 As indicated below, the key tax benefits of a corporate migration generally can include (1) positioning the inverted company to grow internationally outside the U.S. tax net, (2) injecting tax-efficient leverage into the former U.S. parent, and (3) certain "out-from-under" planning to migrate existing CFCs out of U.S. parent.

11 American Jobs Creation Act of 2004 (P.L. 108-357), Act Sec. 801 (Oct. 22, 2004).

12 In addition, Congress also enacted Code Sec. 4985 to impose a further disincentive to invert. That provision imposes an excise tax on the "specified share compensation" of certain insiders of the inverted company.

13 *See* Code Sec. 7874(a)(2)(B)(ii).

14 *See* Code Sec. 7874(a)(2)(B)(iii).

15 *See* T.D. 9654, 79 FR 12 (Jan. 17, 2014). The temporary regulations were also issued as proposed regulations (REG-121534-12).

16 *See* T.D. 9592, IRB 2012-28, 41, 77 FR 113 (June 12, 2012).

17 NY TIMES, Oct. 8, 2013.

18 For a narrative description of this proposal, *see* "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals" (the "Green Book"), available at *www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx.*

19 *Id.,* at 65.

20 *Id.*

21 *Id.*

22 Reg. §1.367(a)-3(c).

23 Notice 2009-78, IRB 2009-40, 452.

24 For example, final regulations were issued last year under Code Sec. 367(a)(5). T.D. 9614, March 18, 2013. Moreover, an important notice was issued relating to various repatriation techniques involving outbound reorganizations. Notice 2012-39, IRB 2012-31, 95.

25 Temporary Reg. §1.7874-3T(b).

26 T.D. 9592, IRB 2012-28, 41, 77 FR 113 at 34786.

27 *Id.*

28 Temporary Reg. §1.7874-3T(b)(1)(i) and (ii).

29 Temporary Reg. §1.7874-3T(b)(2).

30 Temporary Reg. §1.7874-3T(d)(5).

31 Temporary Reg. §1.7874-3T(b)(3).

32 Temporary Reg. §1.7874-3T(d)(7).

33 Temporary Reg. §1.7874-3T(f).

34 *Id.*

35 *Id.*

36 A U.S. spinco is necessary in this situation to avoid taxation to the U.S. distributing corporation under Code Secs. 367(b), 367(e) and 1248(f).

37 Reg. §1.367(b)-10 (replacing former Temporary Reg. §1.367(b)-14T, which was removed by T.D. 9526, 76 FR 28890 (May 19, 2011)).

38 *See* Reg. §1.367(a)-3(a)(2)(iv) and (b)-10(a)(2)(iii).

39 *Id.*

40 The naming of the transactions has been attributed to Lee Sheppard.

41 Notice 2006-85, 2006-2 CB 677.

42 Notice 2007-48, 2007-1 CB 1428.

43 Temporary Reg. §1.367(b)-14T; T.D. 9400, 73 FR 30301 (May 27, 2008).

44 Reg. §1.367(b)-10; T.D. 9526, May 17, 2011.

45 Reg. §1.367(b)-10(b)(2).

46 Reg. §1.367(b)-10(d).

47 *Id.*

48 Reg. §1.956-1T(b)(4).

49 Reg. §1.367(b)-10(a)(2)(iii).

50 *Id.*

51 Reg. §1.367(a)-3(a)(2)(iv).

52 Notice 2009-78, IRB 2009-40, 452.

53 Code Sec. 7874(c)(2)(B) (emphasis added).

54 *See* Reg. §1.7874-4T(c)(1) and (i)(10).

55 *See* Reg. §1.7874-4T(c)(2).

56 *See* Reg. §1.7874-4T(j), Ex. 6.

57 *See* Reg. §1.7874-4T(c)(1) and (i)(7)(iv).

58 Code Sec. 7874(c)(2)(B).

59 Reg. §1.7874-2(h)(1).

60 *See* Reg. §1.7874-4T(d)(1).

61 Notice 2009-78, IRB 2009-40, §4.

62 *Id.;* Reg. §1.7874-4T(i)(6).

63 *See* Reg. §1.7874-4T(j), Ex. 3(ii).

64 *See* Reg. §1.7874-4T(i)(7).

65 *See* Reg. §1.7874-4T(e).

66 *See* Reg. §1.7874-4T(j), Ex. 5(iii).

67 *See* Reg. §1.7874-4T(k).

68 *Id.*

69 Reg. §1.7874-2(i)(2).

70 *Alabama Asphaltic Limestone Co.*, 315 US 179 (1949); Reg. §1.368-1(e)(6).

71 *See, e.g.*, Code Sec. 367(e)(1); Reg. §1.367(e)-1(c).

72 Code Sec. 368(a)(1)(B) and (2)(E).

73 Reg. §1.367(a)-3(c).

74 Reg. §1.7874-3T(f). The deal closed June 28, 2012.

75 *See, e.g.,* Reg. §1.367(a)-3(c)(3)(iii)(B).

76 Code Sec. 7874(c)(4) (addressing both contributions *and* distributions).

77 Code Sec. 7874(c)(4).

78 Reg. §1.367(a)-3(a)(2)(iv) and (b)-10(a)(2)(iii).

79 Reg. §1.7874-2(e).

80 Reg. §1.7874-3T(b).

81 Reg. §1.367(a)-3(c)(1) and (c)(3).

82 Reg. §1.367(b)-10(d).

83 Reg. §1.367(a)-3(b).

84 Reg. §1.7874-2(e).