taxnotes federal

Volume 174, Number 1 ■ January 3, 2022

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Reprinted from *Tax Notes Federal*, January 3, 2022, p. 37

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In this report, Zimet considers how the section 7874 anti-inversion rules apply in a debt restructuring and outlines the myriad traps for the unwary.

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Many companies evaluating the effects of potentially higher U.S. federal income tax rates are considering the merits of an inversion to a foreign holding company structure but wonder whether that's even practical under current anti-inversion rules and proposed statutory changes.

When the maximum U.S. federal corporate tax rate was 35 percent, domestic corporations with foreign subsidiaries often inverted their structures by forming holding companies outside the United States. Congress enacted section 7874, along with other provisions, to deter companies from undertaking those transactions or to reduce or eliminate the tax benefits. While the provisions reduced the number of inversions, they did not eliminate them.

The Tax Cuts and Jobs Act reduced the U.S. corporate rate to 21 percent, with an even lower U.S. effective rate of 10.5 percent on foreign earnings under the global intangible low-taxed income regime. That reduced tax incentives for inversions, causing many global companies to choose to either leave or locate their holding companies in the United States.

This year, President Biden and members of Congress released tax proposals to increase the U.S. corporate rate, as well as the U.S. effective rate on foreign earnings. Although the increase in rates on domestic earnings is now off the table, companies may no longer view the United States as a friendly tax jurisdiction for their holding companies.

With the dislocation of the U.S. economy amid the COVID-19 pandemic, debt restructurings in and outside bankruptcy are on the rise. In a debt workout, companies generally consider an entirely new organizational structure. In many cases, the troubled company must drastically reduce the size of its business or shed several divisions and service lines. In today's environment, companies engaging in a restructuring should also consider whether it is beneficial to invert.

Many articles address nuances of the section 7874 anti-inversion rules, but this one focuses on an area that is generally overlooked: the complicated rules' application in a debt restructuring and the myriad traps for the unwary.

I. What Constitutes an Inversion?

Enacted in 2004, section 7874 applies to inversion transactions in which domestic corporations or partnerships (domestic targets) are acquired by a surrogate foreign corporation. A domestic target, and any U.S. person who is a related to a domestic target (as described in section 267(b) or 707(b)(1)), is considered an expatriated entity, subject to the section 7874 rules. The relationship is determined as of any date on or after the completion date — that is, the date on which the domestic entity acquisition and all related transactions are completed.[1]

A foreign acquiring corporation is a surrogate corporation, and the transaction is treated as an inversion subject to section 7874 if three conditions are satisfied: the substantially all test, the ownership fraction test, and the substantial business activities test.

A. Substantially All Test

The first condition is that a foreign corporation or publicly traded foreign partnership directly or indirectly acquires substantially all the properties of a domestic corporation or partnership that constitute a trade or business. Neither the tax code nor the legislative history to section 7874 provides meaningful insight on how to determine whether the substantially all test is met. The conference report states that "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]

The section 7874 regulations — promulgated between 2008 and 2018 under broad Treasury authority granted in the statute — do not provide any guidance on which transactions meet the substantially all test but do provide that the test is satisfied if substantially all the properties of a domestic target are acquired indirectly through an acquisition of the stock of a domestic corporation or an interest in a partnership. With an acquisition of equity interests instead of assets, the foreign acquiring corporation is treated as acquiring a proportionate amount of properties of the acquired entity. For example, if a foreign corporation acquires 80 percent of the stock of a domestic corporation, the foreign corporation is treated as acquiring 80 percent of the properties of the domestic corporation. However, the section 7874 regulations do not say how to address the common situation of a corporation that has multiple classes of stock or a partnership that has a complex ownership arrangement.

The phrase "substantially all" is used in various contexts for acquiring assets under subchapter C of the code. It has been interpreted in many court cases and IRS rulings. For example, the IRS guidelines for requesting a private letter ruling provide that the substantially all requirement for corporate reorganization purposes is met if the acquiring corporation acquires at least 90 percent of the net assets by value and 70 percent of the gross assets by value. In both cases, the test is determined based on assets held by the target corporation immediately before the transfer.[3]

In bankruptcy reorganizations, such as a type G reorganization, the IRS has generally used a different standard in letter rulings: The acquiring corporation must acquire more than 50 percent of the gross assets by value and 70 percent of the operating assets by value. In both cases, the test is determined based on assets held by the target corporation as of the date the petition for bankruptcy was filed. For those purposes,

[1] Sections 1504(b)(3), 7874(c)(1); and reg. section 1.7874-12(a)(7).

[2] H.R. Rep. No. 108-755, at 570 (2004).

[3] Rev. Proc. 77-37, 1977-2 C.B. 568, modified by Rev. Proc. 89-30, 1989-1 C.B. 895.

operating assets are assets other than cash, accounts receivable, and investment assets, as well as assets that were taken out of operation with the intention of effecting a sale.[4] The IRS has also applied the test in insolvent type D reorganizations.[5]

The IRS and Treasury are not bound by that precedent in drafting guidance. However, in the absence of guidance, precedent is presumably a logical place to start.

B. Ownership Fraction Test

The second condition is met if after the acquisition, former shareholders or partners of the domestic target own at least 60 percent of the stock of the foreign acquiring corporation by vote or value by reason of owning interests in the domestic target.

The section 7874 regulations provide detailed rules for determining whether shares are taken into account in the numerator or denominator of the ownership fraction.[6] Generally, only stock owned by persons that were shareholders or partners of the domestic target before the domestic entity acquisition is taken into account in the numerator.

The regulations provide additional rules, discussed below, that potentially (1) treat a creditor as a former shareholder on the exchange of debt for stock of the foreign acquiring corporation, and (2) recharacterize debt-related payments as issuances of shares of stock of the foreign acquiring corporation. The tax consequences of an inversion depend on the ownership fraction, which can be affected by those two possibilities.

C. Substantial Business Activities Test

The final condition for an inversion transaction is that post-acquisition, the expanded affiliated group that includes the foreign acquiring corporation does not have substantial business activities in the foreign country where the foreign acquiring corporation was created or organized compared with the group's total business activities. That test is determined as of the completion date.

The expanded affiliated group includes a broader set of members than an affiliated group because the test applies an ownership standard of more than 50 percent rather than at least 80 percent, and foreign corporations can be members.

An expanded affiliated group's business activities will be treated as substantial if six requirements are satisfied:

- the number of employees in the relevant foreign country is at least 25 percent of the total number;
- employee compensation in the relevant foreign country is at least 25 percent of the total compensation;
- the value of the tangible assets used in the active conduct of a trade or business in the relevant foreign country is at least 25 percent of the total value of assets;
- the gross income from ordinary course transactions conducted with customers who are not related persons is at least 25 percent of the total gross income;
- the foreign acquiring corporation is a tax resident of the relevant foreign country; and
- the relevant foreign country imposes a corporate income tax.

Whether the first and third requirements are satisfied is generally determined on the completion date or the last day of the preceding month, if applied consistently. Whether the second and fourth requirements are satisfied is generally determined based on the one-year period ending on the date described in the previous sentence.

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[4] *See* LTR 201032009; LTR 201025018; LTR 199941023; LTR 9629016 (90 percent of operating assets test); and LTR 9544026.

[5] *See* LTR 200709018.

[6] Under the rules, there are circumstances in which both the numerator and the denominator can be zero. *See* reg. section 1.7874-6(g), Example 3. The regs do not spell out whether an ownership fraction of zero over zero is treated as 0 percent or 100 percent (or infinity). In LTR 201432002, the IRS treated the situation of zero over zero as not meeting the ownership fraction condition for an inversion transaction to occur.

II. Ownership Fraction Drives Tax Consequences

If section 7874 applies, one of two tax results occurs, depending on the size of the ownership fraction[7]:

- if former shareholders or partners of the inverted domestic entity own at least 80 percent of the acquiring foreign corporation, the new foreign parent is treated as a domestic corporation; or
- if former shareholders or partners own less than 80 percent but at least 60 percent of the acquiring foreign corporation (a minor inversion transaction), the foreign parent is respected as a foreign corporation but is prevented from using tax attributes such as losses and deductions to offset income and gain from the inversion transaction and in later transactions involving assets owned at the time of the inversion.

For an ownership fraction of at least 80 percent, the recharacterization of the surrogate foreign corporation as a domestic corporation is for all purposes of the code, including non-income-tax provisions.[8] A surrogate foreign corporation that is deemed a domestic corporation cannot make a check-the-box election.

The deemed conversion of the surrogate foreign corporation from a foreign corporation to a domestic corporation is treated as a reincorporation that qualifies as a section 368(a)(1)(F) corporate reorganization. The conversion is deemed to take place on the later of the end of the day immediately preceding the first day on which assets were acquired as part of the domestic entity acquisition or immediately after the formation of the foreign corporation.[9]

The transfer of assets by a U.S. person to a surrogate foreign corporation that is treated as a domestic corporation under section 7874 is not subject to section 367. Thus, if the foreign surrogate acquires the domestic entity's stock, the former shareholders of the domestic entity are deemed to have transferred shares of the inverted domestic company to a domestic acquiring company. However, the deemed conversion of the foreign corporation into a domestic corporation is subject to the rules of section 367.[10]

If the ownership fraction is at least 60 percent but less than 80 percent, the expatriated entity is generally not permitted to offset inversion gain with deductions and credits for at least 10 years. Inversion gain is the income or gain recognized by an expatriated entity by reason of the transfer of stock or other properties, or for a license of any property by, an expatriated entity as part of the domestic entity acquisition or, if to a foreign related person, in a later transaction.[11] The limitation on offsets against the tax on inversion gain is discussed below.

Taxpayers are not permitted any exemption from the provisions of section 7874 by reason of any U.S. treaty, including those entered into before the enactment of section 7874 and any subsequent treaties.[12]

In most cases, taxpayers won't want section 7874 to apply to their transactions. However, in a recent private letter ruling,[13] the taxpayer apparently wanted the transaction to be an inversion so that the surrogate foreign corporation would be treated as a domestic corporation. It was understood that the holding company needed to be a foreign corporation for nontax business reasons.

III. Proposed Legislation Targets Inversions

As of the date of publication, it is unclear whether the proposed Build Back Better Act (H.R. 5376) making its way through Congress will include changes to section 7874. The bill passed by the House would impose a 1 percent tax on repurchases of stock by specific surrogate foreign corporations whose stock is publicly traded, but it does not propose any changes to the language of section 7874.

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[7] Other provisions beyond the scope of this report can also apply to inversion transactions — for example, sections 1(h)(11)(B)(iii)(II), 59A(d)(4), 965(l), and 4985; and reg. section 1.7701(l)-4.

[8] Section 7874(b) (if section 7874 applies, it can override the definition of the word "domestic" in section 7701(a)(4)).

[9] Reg. section 1.7874-2(j)(1), (k)(2), Example 20.

[10] *Id.*

[11] Section 7874(a), (d), (e)(1).

[12] There is some uncertainty in whether the provision can in fact override a treaty ratified by the Senate in the future.

[13] LTR 202107009.

The version of the bill being considered by the Senate Finance Committee includes amendments to section 7874 that would change the 60 percent and 80 percent ownership fraction thresholds to more than 50 percent and at least 65 percent, respectively. That is, the inversion rules would apply if the ownership fraction is more than 50 percent and the surrogate foreign corporation would be treated as a domestic corporation if the ownership fraction is at least 65 percent.

The Senate bill would also make major changes to the substantially all test. Now, the test is met if the acquiring corporation acquires substantially all the properties of a domestic corporation, or substantially all the properties of a domestic partnership that constitute a trade or business. The proposal would apply the same test to domestic corporations and partnerships: if the acquiring corporation acquires substantially all the properties of a domestic corporation or partnership, or substantially all the properties of a domestic corporation or partnership that constitute a trade or business.

The Senate version would also apply the section 7874 inversion rules to acquisitions of assets from a foreign partnership. The substantially all test for a foreign partnership would apply if the acquiring corporation acquires substantially all the properties of a foreign partnership that constitute a U.S. trade or business. It is unclear whether assets held by a foreign partnership that are deemed effectively connected with a U.S. trade or business under the 1980 Foreign Investment in Real Property Tax Act will be covered by this provision.

The Finance Committee proposals would apply to tax years ending after December 31, 2021, but only for acquisitions completed after the date of enactment of the Build Back Better Act.

IV. Creditors Complicate Inversion Analysis

Because section 7874 applies only if former equity holders of a domestic target acquire at least 60 percent of the foreign corporation in the transaction, it seems that most debt workouts or bankruptcy reorganizations would not qualify as inversions. However, under the section 7874 regulations, if the domestic target is insolvent or in bankruptcy, stock issued to creditors is treated as owned by a former equity holder and will generally increase the ownership fraction. Similar rules apply to part of any stock issued to creditors that hold convertible debt. Additional rules potentially recharacterize debt-related payments as issuances of shares of stock of the foreign acquiring corporation.

A. Bankruptcy and Insolvency

If a domestic corporation or domestic or foreign partnership is in bankruptcy or is insolvent, creditors that receive shares in partial or full satisfaction of their claims are treated as the entity's shareholders or partners for all section 7874 purposes, and any creditor claim against the entity is treated as equity in the entity. Whether a partnership or domestic corporation is in bankruptcy or is insolvent for section 7874 purposes is determined immediately before the first date that assets are acquired as part of a domestic entity acquisition.

An entity will be treated as in bankruptcy if it has filed for relief in a U.S. bankruptcy court under title 11 of the U.S. code. It will also be treated as in bankruptcy if it is a part of a receivership, foreclosure, or similar proceeding under federal or state law, or if a financial institution, a proceeding before a federal or state agency.[14]

Under the section 7874 regulations, in determining whether an entity is insolvent, the amount of liabilities is compared with the value of the assets. However, by providing an independent definition instead of cross-referencing section 108(d)(3), section 7874 left open many issues resolved for section 108(d)(3) purposes. For example, it is unclear under section 7874 whether a domestic entity qualifies as insolvent or in bankruptcy when it owns a disregarded entity that is itself insolvent or in bankruptcy. That question was resolved for section 108 purposes by regulations providing that the status of the disregarded entity or grantor trust is ignored; instead, the owner must be under the direct jurisdiction of the bankruptcy court or insolvent to qualify for the exclusion of cancellation of debt (COD) income under section 108(a).

[14] Section 368(a)(3)(A), (D); and reg. section 1.7874-2(i)(2)(i).

Further, the section 7874 regulations sometimes differ from the section 108 rules. For example, section 7874 does not limit the effect of the status of insolvency by the amount of insolvency and it does not have a de minimis rule. Thus, if the corporation is insolvent by $100 million and creditors exchange debt for stock worth $500 million, it appears that the entire $500 million of stock will be treated as owned by former shareholders. The same would be true even if the corporation was insolvent by only a small amount (for example, $1).

The section 7874 regulations also do not appear to differentiate between recourse and nonrecourse debt. Under section 108, nonrecourse debt is generally not taken into account for insolvency purposes if the debt exceeds the fair market value of the property secured by the debt. However, that excess nonrecourse debt is taken into account to the extent the debt is discharged.[15]

Some questions remain unanswered for both sections 7874 and 108. For example, how do guarantees factor into the insolvency calculation? A corporation that has guaranteed the debt of a related party might be economically insolvent, but because of its guarantees, it might not be insolvent when considering only its actual liabilities. If a subsidiary with a small amount of borrowed debt guarantees the liabilities of its parent corporation, which is itself insolvent, the subsidiary's equity may have no value, and its creditors might receive only partial payment in a debt workout. Under case law that provides that a taxpayer does not realize COD income on the discharge of a guaranteed obligation, an obligation under a guarantee could be treated as a contingent liability or be ignored because the actual debtor is considering the obligation for insolvency purposes.[16]

Another example is the treatment of contingent liabilities in determining insolvency. In *Merkel*, a case involving insolvency in the section 108 context, the Tax Court addressed whether contingent sales tax liabilities should factor into the insolvency calculation.[17] The court held that the contingent sales tax liabilities were not factored into the analysis because the taxpayer failed to meet his burden of proving that it was "more probable than not that he will be called upon to pay that obligation in the amount claimed." As noted by the Tax Court, that standard is similar to the accrual approach used for contingent liabilities for U.S. accounting purposes.[18]

The only two courts to weigh in on that topic for section 108 purposes used the same approach, but there is still a great deal of uncertainty in whether other courts would use it or another approach (for example, a partial inclusion based on valuations). Similar uncertainty exists under section 7874.

Determining whether a domestic target is in bankruptcy or is insolvent for section 7874 purposes appears to be made immediately before the first asset is transferred from the domestic target to the foreign acquiring corporation or, in a stock acquisition, before the first share is transferred from a shareholder to the foreign acquiring corporation.

Consider an example.[19] Individual A, a U.S. citizen, owns 100 percent of the stock of Target, a U.S. corporation. Target is in bankruptcy. Under a bankruptcy plan, Newco, a newly formed foreign corporation, acquires Target's stock. The Target stock owned by A is canceled, and Target's creditors receive 100 percent of Newco's stock.

Target's creditors are treated as Target shareholders, and the creditor claims are treated as Target stock for section 7874 purposes. The ownership fraction is 100 percent because the creditors received 100 percent of the Newco stock. The result would be the same if the transaction had been structured as an asset acquisition — that is, Newco acquired the assets of Target in exchange for Newco stock, which was distributed to the creditors.

[15] Rev. Rul. 92-53, 1992-2 C.B. 48. *See also* Rev. Rul. 2012-14, 2012-24 IRB 1012 (excess nonrecourse debt of a partnership).

[16] *Landreth v. Commissioner*, 50 T.C. 803, 812-813 (1968), *acq.*, 1969-2 C.B. xxiv; *Bullock v. Commissioner*, T.C. Memo. 2017-219.

[17] *Merkel v. Commissioner*, 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

[18] *See* ASC 450-20-25-2. An estimated contingent loss is taken into account under U.S. generally accepted accounting principles if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

[19] Based on reg. section 1.7874-2(k)(2), Example 19.

When considering an entity's status, note that a foreign proceeding will not be treated as a bankruptcy proceeding. Further, those rules do not apply to stock issued to a creditor of a foreign corporation. As a result, it appears that stock issued to creditors of a foreign subsidiary of a domestic target is not treated as stock of a domestic target even if the foreign subsidiary is in bankruptcy. Also, those shares will generally be treated as disqualified stock (discussed below).

B. Convertible Debt

The section 7874 regulations provide that an option regarding equity in a corporation or partnership is generally treated as equity in the corporation or partnership based on the value of the equity that can be acquired under the option,[20] reduced (but not below zero) by the option's exercise price (the option rule). When the exercise price is payable in property, it is determined based on the property's FMV.

For section 7874 purposes, an option includes interests similar to an option, such as debt obligations and other instruments that are convertible into equity. That means a portion of convertible debt will typically be treated as equity of the issuing corporation or partnership. Presumably, that will apply only if the issuer is solvent and not in bankruptcy — that is, not covered by the discussion above.

In several situations, however, the option rule does not apply. The first is if the probability of the option being exercised is remote, which is determined at the time of the domestic entity acquisition. That exception might apply when the option can't be exercised for a significant period of time or there are practical impediments to the exercise. The second situation is if a principal purpose of the option's issuance or acquisition is to avoid the foreign acquiring corporation being treated as a surrogate foreign corporation. The third situation involves whether treating the option as equity would duplicate a claim on equity by a shareholder. For example, if a shareholder issues a warrant to a third party to acquire stock, the warrant is not taken into account because it would duplicate the stock already owned by the shareholder.

Generally, the holder of an option on a foreign acquiring corporation will not be treated as holding any voting power in the deemed equity attributable to the option. However, the voting power will be attributed to the option holder if a principal purpose of the option issuance or transfer is to avoid the foreign acquiring corporation being treated as a foreign surrogate.

Consider two examples.[21] In the first, Individual A owns convertible debt issued by Target, a U.S. corporation that is solvent and not in bankruptcy. The debt has an FMV of $1.1 million and a face value of $1 million. As part of a domestic entity acquisition, A receives stock of foreign acquiring corporation Foreignco with an FMV of $1.1 million.

A's claim on Target's equity would be $100,000 ($1.1 million - $1 million). That assumes that the FMV of the debt (without the conversion feature) equals $1 million.

The stock received by A that is attributable to the claim on equity ($100,000) is treated as received by a former shareholder. That would be included in both the numerator and the denominator in computing the ownership fraction. It appears that the remaining stock will be treated as disqualified stock and ignored for computing the ownership fraction (see discussion below).

The second example has the same facts, except that Foreignco issues a debt obligation to A with a value of $1.1 million in exchange for Target's debt obligation. The debt obligation issued to A has terms similar to the obligation exchanged for it, except it is convertible into Foreignco stock.

The results would generally be the same ($100,000 of stock included in both the numerator and the denominator), but the deemed shares received by A will generally not be treated as having any voting power.

C. Non-Ordinary-Course Distribution Rules

The rules for non-ordinary-course distributions (NOCDs) could affect the treatment

[20] For a domestic corporation or partnership, the value is determined immediately before the domestic entity acquisition; for a foreign corporation or partnership, it is determined immediately after the domestic entity acquisition.

[21] Based on reg. section 1.7874-2(h)(2), (k)(2), examples 14 and 16.

of transactions involving a domestic target's creditors, and therefore also the ownership fraction and whether an inversion transaction has occurred for section 7874 purposes.

However, before focusing on the effects of applying the NOCD rules, it may be helpful to explain how to determine whether an NOCD occurred, which is based on the distributions made during the lookback period, generally the 36-month period ending on the completion date. Each of the three consecutive 12-month periods that make up the lookback period is a lookback year. For example, if the domestic entity acquisition is completed February 25, 2020, the lookback period is the 36-month period ending February 25, 2020, and the lookback years are the 12-month periods ending February 25 in each of 2018, 2019, and 2020.

The amount of NOCDs made during a lookback year is generally equal to the aggregate amount of all distributions made during the year over the NOCD threshold for the year. That threshold generally equals 110 percent of all distributions made during the distribution history period (generally the 36 months preceding the start of the lookback year) times a fraction equal to the number of days in the lookback year over the number of days in the distribution history period.

Special rules apply to determine the lookback year and period and the distribution history period if a domestic target was formed during the respective 12- or 36-month periods or had a predecessor entity, as well as to exclude specific items from the definition of a distribution.

Essentially, if there was an NOCD, the rules treat the distribution as if the former domestic shareholders or partners received additional stock of the domestic acquired entity (instead of cash or property), which is exchanged for stock of the foreign acquiring corporation. The additional stock is taken into account for determining the ownership fraction by value but not by vote. That deemed stock is in addition to any foreign acquiring corporation stock treated as received by the former shareholders or partners.

Under the NOCD rules, the FMV of the additional foreign acquiring corporation stock equals the amount of the NOCDs received, determined as of the date of the distribution. Consequently, the holder does not take into account appreciation or depreciation in the value of equity from the date of the distribution to the date of the domestic entity acquisition.

Consider an example in which a domestic entity acquisition is completed December 31, 2020. The table shows the distribution history (all in cash) of the domestic acquired entity.

Distribution History

Year	Amount (in cash)
2015	$1 million
2016	$1 million
2017	$1 million
2018	$2 million
2019	$3 million
2020	$2 million

The lookback period consists of calendar years 2018 through 2020, each of which is a lookback year.

For 2018 the distribution history period consists of calendar years 2015 through 2017. Total distributions of $3 million were made during that period, so the NOCD threshold for 2018 is $1.1 million (110 percent * $3 million * 12/36), and the NOCDs for 2018 are $900,000 ($2 million in distributions - $1.1 million NOCD threshold).

For 2019 the distribution history period consists of calendar years 2016 through 2018, during which total distributions of $4 million were made. Therefore, the NOCD threshold for 2019 is approximately $1.47 million (110 percent * $4 million * 12/36), and the NOCDs for 2019 are approximately $1.53 million ($3 million in distributions - $1.47 million NOCD threshold).

For 2020 the distribution history period consists of calendar years 2017 through 2019, during which total distributions of $6 million were made. Therefore, the NOCD threshold for 2020 is $2.2 million (110 percent * $6 million * 12/36), and the NOCD for 2020 is zero (because $2 million in distributions is less than the $2.2 million NOCD threshold).[22]

[22] The excess of the NOCD threshold over the distributions for the year does not appear to reduce the NOCDs for other lookback years.

As a result, the total NOCDs are approximately $2.43 million ($900,000 from 2018 and $1.53 million from 2019), so the former domestic entity shareholders or partners are treated as receiving nonvoting stock in the foreign acquiring corporation with that value.

The NOCD rules might apply to payments made to a domestic target's creditors. As discussed, creditors can at times be treated as former domestic entity shareholders or partners. In that situation, their debt obligations are treated as equity of the domestic target. That recast occurs if the debt obligation is convertible into stock or the domestic acquired entity is insolvent or in bankruptcy. In those cases, payments of interest and principal made for the recast debt obligation might be treated as a distribution made by a domestic target to a shareholder. That said, the section 7874 regulations are silent on whether the NOCD rules apply to payments made for recast debt obligations, and there do not seem to be any cases or rulings on point.

Similar challenges exist regarding section 305 distributions of stock and stock rights. Those rules treat convertible debt obligations as stock, the holder as a shareholder, and interest payments on the debt as cash distributions. These recast cash distributions can result in actual shareholders being treated as receiving deemed stock distributions.

Applying the NOCD rules to payments on those debt obligations could significantly affect the determination of whether an inversion transaction occurred because the rules are applied lookback year by lookback year and not security by security. Payments of interest in lookback years would tend to increase the amount of NOCDs, while payments of interest during the distribution history period could have the opposite effect. Further, if the NOCD rules apply to debt obligations that are treated as stock, it is unclear whether accrued but unpaid interest or original issue discount is taken into account. Under section 301, distributions are generally considered when paid and not when accrued.[23]

[23] *But see* section 305(c); and reg. section 1.305-5(b) (accrual of redemption premiums on preferred stock).

V. Creditors and the Disqualified Stock Rules

The prior section discussed situations in which stock may be deemed issued and whether that results in an inversion transaction. This section considers instances that have the opposite effect — that is, stock received from the foreign acquiring corporation is ignored for determining the ownership fraction and the resulting implications under the anti-inversion rule.

Section 7874(c)(2)(B) provides that a foreign corporation's stock is ignored if it is sold in a public offering related to the domestic entity acquisition, regardless of whether the stock has been or will be publicly traded. The regulations, however, broaden the scope of stock that is ignored for the ownership fraction and override the statutory rule. They provide that disqualified stock is not included in the numerator or the denominator of the ownership fraction unless an exception applies.[24] Stock that is not disqualified stock is taken into account for the ownership fraction even if it is described in section 7874(c)(2)(B). Under the de minimis exception rule, disqualified stock is not excluded from the calculation of the numerator and denominator of the ownership fraction if, without considering the exclusion of disqualified stock, the fraction would be less than 5 percent (and other requirements are met).

The section 7874 regulations generally define disqualified stock as stock of the foreign acquired corporation that is transferred to a person other than the domestic target in exchange for nonqualified property in a transaction that is related to the domestic entity acquisition (the exchange rule). A transfer includes an issuance, sale, distribution, exchange, or any other disposition.

Nonqualified property includes cash and cash equivalents, marketable securities (other than equity in a corporation or partnership that becomes a member of the expanded affiliated group in connection with the domestic entity acquisition), specified obligations, and property

[24] Actually, reg. section 1.7874-4(b) states only that disqualified stock is not included in the denominator without referencing the numerator. However, examples make clear that disqualified stock is not included in the numerator if it is not included in the denominator; *see* reg. section 1.7874-4(i), examples 1-3, 6, and 10.

that was acquired with a principal purpose of avoiding section 7874.

If stock and other property are exchanged for qualified and nonqualified property, the stock is treated as exchanged for each type of property, and its value is allocated between the qualified and nonqualified property based on relative FMV. Only the portion of stock allocated to nonqualified property can be treated as disqualified stock.

Disqualified stock does not include stock of a foreign corporation that is held by reason of holding equity in a domestic corporation or partnership. As a result, stock of a foreign corporation received in exchange for equity in a domestic corporation or partnership is not treated as disqualified stock. Similarly, stock of a foreign corporation received by a domestic partnership in exchange for some or all of the partnership's assets is not treated as disqualified stock. If, as part of the same transaction, stock of a foreign corporation is received in exchange for equity in a domestic corporation or partnership and other property, the transaction is bifurcated. The foreign corporation stock is treated as received for each type of property (equity and other property) based on the relative FMV.

Stock is considered disqualified only if the transfer results in an increase in the FMV of the foreign acquiring corporation's assets or a decrease in its liabilities, determined without regard to any other exchange or transaction related to the domestic entity acquisition. For example, if a person acquires stock of a foreign acquiring corporation from a shareholder for nonqualified property in a transaction related to the domestic entity acquisition, the stock would normally be considered disqualified. But because the sale is between shareholders, the foreign acquiring corporation's assets and liabilities remain unchanged, and all the stock transferred is qualified for computing the ownership fraction.

A. Applying Disqualified Stock Rules to Obligations

Nonqualified property includes obligations owed by a specified obligor, defined as:

- a member of the expanded affiliated group (or a partnership that is more than 50 percent owned by value by members of the expanded affiliated group), unless the person who is the holder immediately before the domestic entity acquisition is a member of the group after the acquisition;
- a former domestic entity shareholder or partner that owns directly or indirectly by attribution at least 5 percent by vote or value of the domestic target before the domestic entity acquisition;
- any person (other than a member of the expanded affiliated group) that owns directly or indirectly by attribution at least 5 percent by vote or value of the domestic target before or after the domestic entity acquisition; or
- any person (other than a member of the expanded affiliated group) that is a related person (under section 267 or 707(b), determined before or after the domestic entity acquisition) to a member of the expanded affiliated group or a person described in the second bullet.

According to the disqualified stock rules, an obligation includes any fixed or contingent obligation to make a payment or provide value. That can be, for example, a debt, environmental, tort, or contractual obligation, as well as an obligation regarding a short sale, option, forward or futures contracts, swap, or other derivative financial obligation.

Whether an item is an obligation is determined without regard to its treatment under other code provisions. Thus, nominal debt that is otherwise disregarded for tax purposes might be treated as an obligation under section 7874.

Items treated as stock under section 7874, such as those described in reg. section 1.7874-2(i), are not treated as obligations. Thus, creditor claims for a domestic target entity that is insolvent or in bankruptcy are not treated as obligations, and stock received in exchange for the claim is not generally treated as disqualified stock.[25]

If creditors receive stock of the foreign acquiring corporation in exchange for or in satisfaction of a debt obligation, the stock will

[25]The insolvency or bankruptcy exception to disqualified stock treatment might not apply to creditor claims that are treated as marketable securities. Those claims would be treated as disqualified stock regardless of whether they qualify as obligations. *See* reg. section 1.7874-4(h)(2)(ii).

generally be treated as disqualified stock if the exchange is related to the domestic entity acquisition and the debt obligation is owed by a specified obligor. If the debt is owed by the domestic target, it will generally satisfy the test, and the stock will be treated as disqualified.

A specified obligor generally includes all members of the expanded affiliated group. As a result, an exchange of stock for a group member's debt obligation will be treated as disqualified stock even if the obligor is someone other than the domestic target.

If at least one member of the expanded affiliate group owns more than 50 percent of a partnership by value, the partnership is treated as a corporation that is a member of the group. Presumably, that is determined as of the completion date, and an exchange of stock for a debt obligation of a controlled partnership will also be treated as disqualified stock.

A debt obligation owed by a member of the expanded affiliated group is not treated as nonqualified property if the holder of the debt obligation (or its successor) is also a member of the expanded group. The holder is determined immediately before the domestic entity acquisition and any related transactions that occur, while group members are determined after the domestic entity acquisition and related transactions. That means an exchange of intercompany debt for stock will generally not result in disqualified stock treatment.

The disqualified stock rules can also apply to issuances of stock for debt owed by equity holders. Debt owed by a former domestic entity shareholder or partner can be treated as nonqualified property if the person directly or indirectly by attribution owns at least 5 percent by vote or value of the domestic target before the domestic entity acquisition. Similarly, debt owed by a person that is not a member of the expanded affiliated group can also be treated as nonqualified property.

If a person (other than a foreign corporation) that owes the debt obligation is insolvent or in bankruptcy, the debt is generally not treated as an obligation, and the stock is not treated as disqualified. Rather, the creditor is treated as a former shareholder or partner of the entity, and the stock is generally counted in the numerator and denominator of the ownership fraction.

Consider an example.[26] Individual A, a U.S. citizen, owns 100 percent of the stock of Target, a U.S. corporation, and a debt obligation with an FMV and face amount of $25 million. Target is solvent and not in bankruptcy. Its stock has an FMV of $75 million. Newco, a newly formed foreign corporation, acquires Target's stock and debt for 100 percent of Newco's stock, which has an FMV of $100 million.

Target is a member of the expanded affiliated group because Newco owns 100 percent of its stock after the transaction. A, the holder of the obligation before the exchange, is not a member of the expanded affiliated group after the transaction because it is not a corporation. The issuance of the stock in exchange for the debt obligation increases Newco's assets — that is, it received an increased amount of Target stock. Consequently, the stock issued to A in exchange for the debt is considered disqualified stock.

Because the stock issued for the debt is disqualified, it is not counted in the numerator or denominator of the ownership fraction. Even so, the ownership fraction is still 100 percent ($75 million/$75 million), because A owns 100 percent of Newco's stock after the transaction.

B. Associated Obligations

Disqualified stock rules also apply to stock issued in exchange for property if the stock is later used in the satisfaction or assumption of an obligation that is considered an associated obligation.

That associated obligation rule generally applies if the stock is later used by the transferee (the person who acquired the stock) to satisfy an obligation of it or a related person (under section 267 or 707(b)). The rule also applies if the transferee transfers the stock in exchange for the assumption of its obligation (or that of a related person) or exchanges the stock for other property, which is used to satisfy an obligation (or is issued in exchange for the assumption of an obligation). The rule does not apply if the obligation that is

[26] Based on reg. section 1.7874-4(i), Example 6(i), (ii). See the next example, *infra*, for a similar transaction structured as an asset transfer.

satisfied or assumed is owed by a person (other than a foreign corporation) that is insolvent or in bankruptcy.

The associated obligation rule gets its name from rules that limit its application to obligations associated with transferred property. The amount of stock treated as disqualified stock under the associated obligation rule is limited, depending on the type of transferee. If the transferee is a domestic entity, the limit is the proportionate share of obligations associated with the property exchanged for stock that are not assumed by the person that transferred stock to the transferee under the same plan (or a series of related transactions). The proportionate share is determined based on the FMV of the exchanged assets relative to the FMV of all assets with which the obligations are associated.

If the transferee is not a domestic entity, the limit on the amount of disqualified stock is generally determined in a manner similar to that described above. However, the result is multiplied by a fraction whose numerator is the amount of exchanged property that is qualified property and denominator is the total amount of exchanged property.

The section 7874 regulations do not explain how to determine whether an obligation is an associated obligation, but they do provide an example in which an obligation that arose from a trade or business that had used the property was an associated obligation, regardless of whether the obligation had been nonrecourse.

The limitation on disqualified stock — the increase in FMV of the foreign acquiring corporation's assets or decreases in liabilities — also applies under the associated obligation rule.

Consider an example.[27] Individual A, a U.S. citizen, owns 100 percent of the stock of Target, a U.S. corporation, and a debt obligation with an FMV and face amount of $25 million. Target is solvent and not in bankruptcy. The debt of $25 million is associated with Target's assets and is its only liability. Its assets have an FMV of $100 million. Newco, a newly formed foreign corporation, acquires Target's assets for 100 percent of Newco stock, which has an FMV of $100 million. Target liquidates and distributes the Newco stock to A (75 percent of which is in redemption of the stock and 25 percent in redemption of the debt).

Newco's stock was issued in exchange for assets and later used by Target (the transferee) to satisfy debt it owed to A. As a result, the associated obligation rule applies, and some or all of the stock used to satisfy the debt will be treated as disqualified.

The $25 million obligation owed to A was not assumed by Newco (the transferor) in exchange for Target's assets (the exchanged property). Because it is the only obligation associated with the exchanged assets, and because Newco acquired all of Target's assets, 100 percent of the stock associated with the $25 million obligation is treated as disqualified stock.

The transfer of the Newco stock for Target's stock resulted in a $100 million increase in the FMV of Newco's assets, so the limitation is not reduced below $25 million.

Because the stock issued for the debt is disqualified, it is not counted in the numerator or the denominator of the ownership fraction. Because A owns 100 percent of Newco's stock, after the transaction, the ownership fraction is still 100 percent ($75 million/$75 million).

Consider another example.[28] Individual A owns 100 percent of the stock of DTarget, a solvent U.S. corporation, whose stock has an FMV of $100 million. Individual B owns 100 percent of FTarget, a foreign corporation that conducts businesses C and D. C consists of assets with an FMV of $70 million and associated obligations of $20 million. All of C's assets consist of qualified property. D consists of assets with an FMV of $45 million and associated obligations of $35 million.

A transfers 100 percent of DTarget's stock to Newco, a newly formed foreign corporation, in exchange for 100 percent of the Newco stock (with an FMV of $100 million). In a related transaction, Newco acquires all of C's assets from FTarget for Newco stock (with an FMV of $70 million). FTarget then transfers $30 million of the Newco stock to some of its creditors (both C and D) in satisfaction of $30 million of its liabilities.

[27] Based on reg. section 1.7874-4(i), Example 6(iii).

[28] Based on reg. section 1.7874-4(i), Example 10(i), (ii).

The Newco stock issued to FTarget was in exchange for assets and was later used by FTarget (the transferee) to satisfy its debts associated with C. As a result, the associated obligation rule applies and some or all of the stock used to satisfy the debt will be treated as disqualified stock.

Newco (the transferor) did not assume the $20 million obligation owed to C's creditors in exchange for C's assets (the exchanged property). The amount of stock treated as disqualified is $20 million (($20 million (the associated obligations) * $70 million (the amount of exchanged property that is qualified property))/$70 million (the amount of exchanged property)).

The transfer of the stock to FTarget for C's assets resulted in a $70 million increase in the FMV of Newco's assets, so the limitation is not reduced below $20 million.

Because $20 million of the stock issued to FTarget is disqualified, the $20 million is not counted in the numerator or the denominator of the ownership fraction. Accordingly, the denominator is $150 million ($170 million - $20 million), and the ownership fraction is 66.67 percent ($100 million/$150 million).

The result would be identical if FTarget sold some of the Newco stock for $30 million and then transferred the cash to creditors. It is irrelevant whether FTarget pays off C and D's creditors.

C. Satisfaction or Assumption of Obligations

Reg. section 1.7874-4(e) provides a confusing assumption rule regarding the satisfaction or assumption of an obligation (as defined in the disqualified stock rules section). It applies if, in a transaction related to the domestic entity acquisition, stock of the foreign acquiring corporation is transferred in exchange for the satisfaction or assumption of at least one of the transferor's obligations. The rule does not apply if the stock is transferred to the domestic target.

If the assumption rule applies, the stock of the foreign acquiring corporation is treated as if it were transferred for an amount of cash equal to the stock's FMV.[29] Because cash is treated as nonqualified property, it seems the rule results in treating the stock as disqualified stock.

The assumption rule doesn't apply if the debtor entity is insolvent or in bankruptcy, and those liabilities are not considered obligations. It also doesn't apply to stock that's treated as disqualified stock under the associated obligation rules. As a result, reg. section 1.7874-4(e) appears to apply when stock is issued in exchange for the assumption of an obligation, and the associated obligation rule does not apply to some or all of the assumed obligations.

There is no similar exception for stock that is disqualified because it was exchanged for an obligation that is nonqualified property under the exchange rule. As a result, the assumption rule appears to override the exchange rule if both provisions would otherwise apply (based on the regulatory wording). However, the alternative facts of one regulatory example apply the exchange rule rather than the assumption rule to foreign acquiring corporation stock that was transferred in satisfaction of an obligation.[30]

When the exchange rule applies, stock that is issued in satisfaction of the obligation is treated as disqualified property. Because reg. section 1.7874-4(c)(1)(i) and (e) appear to produce the same result, it is unclear when (e) applies to a satisfaction of debt. The exchange rule is broader than the assumption rule in that it covers exchanges of foreign acquiring corporation stock for nonqualified property (including obligations owed by members of the expanded affiliated group and related persons), and the assumption rule covers only stock transferred in satisfaction of the transferor.

VI. Substantially All

One of the requirements for an inversion transaction is that the foreign acquiring corporation must acquire substantially all the properties held directly or indirectly by a domestic corporation (or substantially all the properties constituting a trade or business of a domestic partnership). For a debt workout, it is typical for a bankrupt or insolvent entity to sell significant parts of the business to third parties for cash. That cash is used to fund payments to secured and senior creditors, while more junior

[29] Solely for reg. section 1.7874-4 purposes.

[30] *See supra* note 26 and accompanying text.

creditors might receive equity. If a troubled domestic entity transfers substantially all its assets to third parties for cash, an inversion to a foreign acquiring corporation might not meet the requirements of section 7874.

A sale of assets before a transaction might not prevent the substantially all test from being met. If the cash from the sale is transferred to the acquiring corporation, it is taken into account. In Rev. Rul. 88-48, 1988-1 C.B. 117, the IRS treated a sale of 50 percent of the historic assets to an unrelated person as not preventing a transaction from meeting the substantially all test. The agency said that if the transferor corporation or its shareholders had retained the cash, a different result might have applied. In a bankruptcy or debt workout, if the cash proceeds are transferred to creditors and not acquired by the foreign acquiring corporation, the cash might not be taken into account.

Section 7874 refers to an acquisition of substantially all the properties of a domestic entity (but not the assets). At least one court has concluded that the word "properties" is narrower than the word "assets" and does not include excess cash that is not needed in the business; instead, properties include operating assets, including cash that is needed for working capital.[31] The IRS might argue that assets that are no longer needed in the business and are sold for cash are not properties for the substantially all test.

Rev. Rul. 88-48 might be applied by a taxpayer to support treating a pre-inversion sale of assets for cash as preventing the substantially all test from being met. To take that position, the cash would need to be distributed to shareholders or creditors.

The IRS might argue that assets that are sold for cash do not count for the substantially all requirement. In bankruptcy reorganizations, the IRS has often applied the 70 percent operating asset test by not treating as an operating asset items that are taken out of operation with the intention of effectuating a sale.[32]

VII. Different Treatment for Multiple Targets

The section 7874 regulations differentiate between creditors of entities (other than foreign corporations) that are insolvent or in bankruptcy. Generally, creditors of bankrupt or insolvent entities that receive stock are treated as former shareholders or partners of the entity. Shares received by creditors of other entities are generally disregarded. Those determinations seem to generally be made by entity. That can result in different treatment for creditors that receive stock in the same debt workout.

Consider an example.[33] Target, a U.S. corporation, owns 100 percent of both DS, a U.S. corporation, and FS, a foreign corporation. Both Target and FS are insolvent, but DS is not insolvent or in bankruptcy. Under a debt workout, 100 percent of Target's stock is transferred to Newco, a newly formed foreign corporation, in exchange for 100 percent of Newco stock. The Target stock owned by preexisting shareholders is canceled for zero consideration. The creditors of Target, DS, and FS each receive one-third of the stock of Newco.

Because Target is insolvent, its creditors are treated as former shareholders for ownership fraction purposes. DS's creditors are not treated as former shareholders because DS was not insolvent or in bankruptcy. FS's creditors are also not treated as former shareholders because the insolvency of foreign corporations is irrelevant. The shares received by creditors of DS and FS are treated as disqualified shares and ignored for ownership fraction purposes. As a result, the ownership fraction is 100 percent because Target's creditors own 100 percent of the Newco stock.

Assume instead that Newco acquires trade or business assets from a corporation that was formed in the same country as Newco. As part of the acquisition, the acquiring corporation receives 25 percent of Newco's stock in the exchange, and the creditors of Target, DS, and FS each receive 25 percent of Newco stock in exchange for debt. It appears that the ownership fraction has been reduced to 50 percent and that the transaction is not an inversion because the creditors of DS and

[31] *Gross v. Commissioner*, 88 F.2d 567 (5th Cir. 1937).

[32] *See* LTR 201025018; LTR 199941023; LTR 9629016; and LTR 9544026. Other rulings do not indicate whether assets taken out of operation are considered operating assets; *see* LTR 201032009 and LTR 200709018.

[33] *See* reg. section 1.7874-2(i), (iii); 1.7874-4(c)(1)(i), (h)(2)(iii)(A), (3); and 1.7874-9(c)(2).

FS are not counted in the numerator or denominator of the ownership fraction.

The section 7874 regulations provide for aggregation when a foreign acquiring corporation acquires multiple domestic targets. That aggregation rule applies if more than one domestic corporation or partnership is acquired "pursuant to a plan (or a series of related transactions)."[34] In computing the ownership fraction, the acquisitions are treated as a single acquisition, and the domestic targets are treated as a single domestic entity. The stock of the foreign acquiring entity received by former domestic target shareholders or partners is aggregated.

Consider an example.[35] Individual A, a U.S. citizen, owns 100 percent of the stock of Target 1, a U.S. corporation. Individual B, a U.S. citizen, owns 100 percent of the stock of Target 2, a U.S. corporation. A and B transfer all their stock in targets 1 and 2 to Newco, a newly formed foreign corporation, in exchange for 100 percent of the Newco stock.

Because Newco acquired substantially all the properties of both targets 1 and 2 (and the acquisitions were related transactions or part of a plan), the aggregation rule applies. As a result, both A and B are treated as former domestic target shareholders, and the aggregated ownership fraction is 100 percent.

An acquisition of a domestic target is taken into account for the aggregation rule only if the acquisition is a domestic entity acquisition — that is, an acquisition of a domestic target that meets the substantially all test. It also includes a successor to that kind of domestic target. The aggregation rule does not seem to apply to the acquisition of a domestic entity if the substantially all test is not met. Example 7 of reg. section 1.7874-2 strengthens the argument that the aggregation rule applies only to a domestic entity if the substantially all test is met.

As described above, creditors are treated as former shareholders or partners of a domestic corporation or domestic or foreign partnership if the entity is in bankruptcy or is insolvent. That rule appears to apply if creditors of a subsidiary (other than a foreign corporation) of a domestic target receive stock of the foreign acquiring corporation in satisfaction of the debt. If creditors of a domestic subsidiary receive stock in a transaction in which the domestic subsidiary meets the substantially all test, the aggregation rule appears to apply. However, if the substantially all test is not met, then it appears that the two acquisitions are not aggregated, and the stock received by the domestic subsidiary's creditors is included in the denominator of the ownership fraction but not the numerator. For example, if a domestic subsidiary transfers substantially all its properties to a third party for cash, and its creditors receive the cash and stock of the foreign acquiring corporation, it is possible that the foreign acquiring stock would be included only in the denominator.

VIII. Inversion Transaction Consequences

A domestic entity's plan to invert will likely be derailed if the ownership fraction is at least 80 percent, resulting in the foreign acquiring corporation being treated as a domestic corporation for U.S. tax purposes. The consequence is the same as if an inversion had not been attempted. Still, it might be worth the effort if there are good arguments that section 7874 does not apply.

For acquisitions resulting in an ownership fraction below 80 percent, the consequences will depend on the additional taxes imposed that wouldn't have been without the transaction. In many cases, the tax consequences of a minor inversion transaction (60 to 80 percent ownership fraction) could be worse than if no inversion had been attempted. Because of the potential effects of section 7874, taxpayers faced with a potential minor inversion transaction might want to increase the ownership fraction above 80 percent or abandon the inversion altogether.

Applying the section 7874 anti-inversion regime to a so-called Bruno's transaction highlights the potentially severe consequences in a debt restructuring if the ownership fraction is between 60 and 80 percent. A Bruno's transaction is a common structure for debt workouts in which the debtor transfers the business in a taxable transaction to recognize the built-in gain on the

[34] Reg. section 1.7874-2(e).

[35] Based on reg. section 1.7874-2(k)(2), Example 7.

assets and avoid or reduce the tax liability on the step-up in basis using net operating losses and other tax attributes that might otherwise not be valuable after the transaction because of the section 382 limitations and the section 108(b) rules on tax attribute reductions.

For a minor inversion transaction, an expatriated entity's taxable income for any tax year that includes a portion of the applicable period cannot be less than the entity's inversion gain for the tax year.[36] As a result, losses and deductions (including NOL and capital loss deductions) that would otherwise be available to reduce tax on inversion gains cannot be used. Credits are available but are severely limited (see below discussion).

A U.S. person, including an individual, that on or after the completion date directly or indirectly owns more than 50 percent of the stock[37] of a domestic target will generally be considered an expatriated entity.[38] As a result, gain recognized by that shareholder in a domestic entity acquisition might be treated as inversion gain.[39] For example, if a shareholder exchanges domestic target stock for more than 50 percent of the stock in the foreign acquiring corporation, any gain recognized might be treated as inversion gain. A similar result could apply to a creditor who acquires a majority of the stock of the foreign acquiring corporation.

The applicable period is the period between the first date that properties are acquired as part of a domestic entity acquisition and the date 10 years after the completion date. So if properties are acquired in a domestic entity acquisition from January 1 to June 30, 2021, the applicable period would run from January 1, 2021, to June 30, 2031.

Inversion gain is defined as the income or gain recognized (including an amount treated as a dividend under section 78) by reason of a transfer during the applicable period of stock or properties by an expatriated entity. It also includes any income taken into account during the applicable period from an expatriated entity's license of property.

Income or gain is treated as inversion gain only if the transfer or license of property is part of the domestic entity acquisition or takes place after the acquisition and the transfer is to a foreign related person. A foreign related person is a foreign person that is related to an expatriated entity — that is, bears a relationship described in section 267(b) or 707(b)(1) — or is under the same common control as an expatriated entity (within the meaning of section 482).[40] Inversion gain does not include income or gain from the transfer or license after the domestic entity acquisition if the property is considered inventory or property held primarily for sale to customers in the ordinary course of a trade or business in the hands of the transferor or the licensor.[41]

The statutory language appears to apply only to transfers of property during the applicable period and income received during the appliable period.[42] The section 7874 regulations potentially expand that to cover income or gain recognized for any tax year that includes any portion of the applicable period. As a result, a transaction that occurs before the beginning or after the end of the applicable period could result in inversion gain.

The regulations provide a single example to assist taxpayers in determining the amount of inversion gain. In the example, a domestic corporation is acquired by a foreign acquiring corporation. A foreign subsidiary of the domestic target — that is, a controlled foreign corporation — later sells non-inventory assets at a gain to the foreign acquiring corporation. The domestic target recognizes subpart F income as a result of the transaction. The subpart F income (and any related section 78 dividends) are treated as inversion gains.[43]

If a taxpayer is unable to use an NOL because of the inversion gain, the NOL is not reduced by the inversion gain and continues to be available for use in future years, generally after the

[36] Section 7874(a)(1).

[37] By value for an individual and by vote or value for a corporation. Different rules apply to partnerships, trusts, and estates.

[38] Sections 267(b)(1), (2), (f)(1), and 7874(a)(2)(A)(ii); and reg. section 1.7874-12(a)(8)(ii).

[39] John L. Harrington, "Corporate Inversions," 6105 *Tax Mgmt. Port.* (BNA), at Section V.C.1.d.

[40] Section 7874(d)(3); and reg. section 1.7874-12(a)(11).

[41] Sections 1221(a)(1), 7874(d)(2); reg. section 1.7874-11(b)(2).

[42] Section 7874(d)(1).

[43] Reg. section 1.7874-11(e), discussed in further detail below.

applicable period.[44] There are no similar rules for other tax attributes (for example, capital losses). As a result, the attributes might be lost in a tax year in which they can't be applied against an inversion gain.

An expatriated entity can apply tax credits other than the foreign tax credit. However, the credits are limited to the amount by which the income tax for the tax year exceeds the amount of tax that would have applied if the inversion gain were taxable at the highest corporate tax rate (currently 21 percent). For a partner in a partnership that is an expatriated entity, the rate is the highest applicable to the partner. Those credit limitation rules effectively mean that credits can reduce tax only for income or gain that is not considered inversion gain.

FTCs are not subject to any special limitation. However, for the section 904 FTC limitation, any inversion gain is treated as U.S.-source income.[45] That effectively disallows the ability to offset FTCs against U.S. federal income tax on inversion gains.

Expatriated entities that are partnerships are subject to special rules; the rules that apply to inversion gains apply to the partners and not the partnership. The inversion gain of the partner equals the sum of the partner's distributive share of the partnership's inversion gain and any gain recognized by the partner by reason of a transfer of any partnership interest to the surrogate foreign corporation.

The statute of limitations for assessing tax attributable to an inversion gain for any pre-inversion year is extended until three years from the date the IRS is notified of the inversion transaction. A pre-inversion year is any tax year that ends before the tax year that includes the completion date or that includes any portion of the applicable period. Those provisions override any law or rule of law that would otherwise prevent an assessment. No guidance has been issued regarding how to notify the IRS of an inversion. Form 8806 might be considered sufficient notification, but not all parties to an inversion transaction are required to file the form.

Consider the single example mentioned above.[46] Target, a U.S. corporation, owns 100 percent of FS, a foreign corporation that is a CFC. Target is in bankruptcy, and its creditors are expected to receive 100 percent of its stock in a bankruptcy plan of reorganization. It is anticipated that Target will realize COD income of $1 billion.

Target has assets with a built-in gain of $600 million (excluding the FS stock). FS has operating assets with a built-in gain of $400 million (and Target has built-in gain of $400 million for the FS stock). Target also has an NOL carryforward of $1 billion.

If Target's bankruptcy plan were to be structured as a stock deal — that is, if creditors receive 100 percent of the stock — Target would realize COD income of $1 billion, which would be excluded under the bankruptcy exception, and the NOLs would be reduced to zero.[47] There would be no NOLs available to offset future income or the recognition of gain on sale of assets.

If Target's bankruptcy plan were to be structured as a Bruno's transaction — that is, the gain on the assets is treated as recognized — Target would recognize $600 million of gain from the sale of operating assets and $400 million of GILTI inclusion income from the sale of FS's assets. That would reduce the NOL carryforward to zero. Target would still realize COD income of $1 billion (which it would exclude under section 108) but would no longer have any tax attributes to reduce (because tax attribute reduction occurs at the end of the tax year).

Based on the above analysis, Target decides to structure its bankruptcy plan as an asset sale.

During Target's time in bankruptcy, Foreignco, a foreign corporation that is Target's competitor, offers to purchase all the Target and FS assets for cash and Foreignco stock. Target accepts Foreignco's offer, and at closing, its creditors receive 75 percent of the stock of Foreignco; Foreignco's existing shareholders continue to own the remaining 25 percent. The parties structure the transaction so that it does not

[44] Sections 860E(a)(3) and 7874(e)(3).

[45] Section 7874(e)(1).

[46] *See supra* note 44.

[47] Section 108(a)(1)(A), (b)(1), (2)(A), (3)(A), (d)(2), (e)(8)(A).

meet the requirements of section 351 or a corporate reorganization.

The acquisition of Target's assets appears to be an inversion transaction with an ownership fraction of 75 percent. As a result, Foreignco retains its status as a foreign corporation. But inversion gains recognized by Target cannot be offset by NOLs.

The $600 million of gain recognized by Target for assets transferred to Foreignco seems to be an inversion gain. The transfer takes place during the applicable period as part of a domestic entity acquisition.

The $400 million of gain recognized by FS for the assets transferred to Foreignco will generally result in a GILTI inclusion to Target (the example ignores the reduction for qualified business asset investments). That income inclusion also appears to be an inversion gain.

It seems that Target will have inversion gain of $1 billion and taxable income of at least $1 billion. The NOL will be unavailable to reduce the inversion gain. Based on those facts, Target could owe U.S. federal income tax of $210 million (based on the 21 percent rate).[48]

If the ownership fraction had been at least 80 percent, Target would not have been subject to the rules on inversion gain limitation. Instead, Foreignco would have been treated as a domestic corporation, which is possibly a better result.

IX. Conclusion

The anti-inversion rules, as they apply to debt workouts, can produce unexpected results and planning opportunities and can serve as traps for the unwary. While the section 7874 rules and regulations are among the most complicated in U.S. tax, the application in the debt workout context produces even more conceptual and interpretive difficulties.

Like many other complex tax provisions, the inversion rules require detailed, complicated modeling. The substantially all, ownership fraction, and substantial business activities tests beg for spreadsheet analysis. Likewise, the potential benefits of a successful (or failed) inversion will need to be modeled and compared with other alternatives (such as remaining in the United States). ■

[48]The section 250 deduction might be available to reduce the income inclusion for the GILTI inclusion.