US Inbound Newsalert

A Washington National Tax Services (WNTS) Publication

June 8, 2012

New section 7874 regulations significantly narrow ability to claim substantial business activities in a foreign country

The IRS and Treasury have raised the bar for US multinationals that seek to change their parent company's country of incorporation. New final, temporary and proposed regulations under section 7874 were issued on June 7, 2012, and require such companies to have 25 percent of their employees, property, and income in that foreign country. Otherwise the new parent company may be treated as a domestic corporation for US tax purposes.

Background

Under section 7874, if a foreign corporation acquires substantially all of the properties of a domestic corporation or partnership, and, by reason of their equity interest in the domestic entity, the shareholders or partners receive at least 80 percent of the vote or value of its stock, the foreign corporation generally is treated as a domestic corporation for US federal income tax purposes. If, on the other hand, the shareholders or partners receive at least 60 percent, but less than 80 percent, of the vote or value of the foreign corporation's stock, the domestic entity generally is limited in its ability to use tax attributes (such as NOLs and credits) to reduce its US tax on income from certain transactions with related foreign persons for a ten-year period. These rules do not apply however if, relative to the group's worldwide business activities, the group conducts substantial business activities in the foreign corporation's country of organization.

pwc

A temporary regulation under section 7874 was issued in 2009 and, pursuant to section 7805(e), was scheduled to sunset on June 8, 2012. The final regulations replace those temporary regulations, which in turn replaced earlier temporary regulations issued in 2006. In addition, the IRS and Treasury issued proposed and temporary regulations that address when a foreign corporation will be treated as meeting the substantial business activities standard in the statute.

New final regulations address acquisitions and ownership test

The new final regulations make several changes to the rules for determining whether a foreign corporation has acquired the properties of a domestic corporation and whether the former shareholders have the requisite 60 percent or 80 percent continuity of ownership. In this regard, the final regulations provide rules with respect to the treatment of options and similar interests, the treatment of creditors of corporations or partnerships that are insolvent or in bankruptcy, and the aggregation of multiple acquisitions.

Of particular note, the new regulations purport to "clarify" that the acquisition by a foreign corporation of its own stock from a domestic corporation or partnership (for example, in a downstream reorganization) counts as the acquisition of property for purposes of section 7874, regardless of the fact that the acquired stock no longer exists after the acquisition.

PwC Observation: Despite its description in the preamble as a clarification, this new rule is a significant change from the 2009 temporary regulations. In a downstream reorganization of a US holding company into a foreign subsidiary, the domestic company's former shareholders ultimately acquire its assets, namely, the foreign subsidiary's shares --and the foreign subsidiary itself might own no more assets than before the transaction. Thus, it is difficult to square the regulatory rule with the statutory language.

As noted above, continuity of ownership is tested based on vote or value. For purposes of testing ownership by value, options and similar interests count as stock. In this regard, the final regulations generally follow the 2009 temporary regulations. For purposes of testing ownership by vote, however, the final regulations treat an option as exercised only if a principal purpose for issuing or acquiring the option was to avoid the application of section 7874. Additionally, the new regulations contain an anti-abuse rule applicable to options with respect to both foreign and domestic corporations and partnerships, whereas the former temporary regulations contained an anti-abuse rule applicable only to options with respect to foreign entities.

The new final regulations apply to acquisitions completed on or after June 7, 2012.

New temporary regulations on substantial business activities

As noted above, section 7874 does not apply if, after the acquisition, the "expanded affiliated group" that includes the foreign corporation has substantial business activities in the foreign corporation's country of incorporation.

Both the 2006 temporary regulations and the 2009 temporary regulations provided, as a general rule, that the determination as to whether the group had substantial business activities in a foreign jurisdiction was based upon all the facts and circumstances. However, the 2006 temporary regulations also provided a safe harbor, under which the group was generally deemed to have substantial business

activities in a foreign jurisdiction if at least ten percent of its employees, assets, and sales were in the foreign jurisdiction (the "2006 safe harbor"). The 2009 temporary regulations removed the 2006 safe harbor as well as all of the examples applying the facts and circumstances test.

The new temporary regulations replace the facts and circumstances test with a bright-line rule. Specifically, an expanded affiliated group will be considered to have substantial business activities in a foreign jurisdiction only if 25 percent of its employees, assets, and gross income are in that jurisdiction. The regulations provide that if one or more members of the expanded affiliated group hold, in the aggregate, more than 50 percent of the value of the interests in a partnership, then the partnership is treated as a corporation that is a member of the group, and all of the partnership's items are taken into account for purposes of the test. Otherwise, no partnership items are taken into account.

To meet the employee test, the group must consider both headcount and compensation. First, the number of group employees based in the foreign jurisdiction must be at least 25 percent of the total number of group employees as of the "applicable date" (which is generally the acquisition's completion date or the last day of the month preceding the acquisition's completion date). Second, at least 25 percent of the compensation paid to the group's employees must have been paid to employees based in the foreign jurisdiction during the "testing period." The "testing period" is one year, ending on the applicable date.

To meet the asset test, at least 25 percent of the group's tangible personal property and real property used or held for use in the active conduct of a trade or business must be in the foreign jurisdiction on the applicable date. For this purpose, rental property is included at eight times the net annual rent paid with respect to such property.

To meet the income test, at least 25 percent of the group's income for the testing period from transactions occurring in the ordinary course of business must be derived from transactions with unrelated customers located in the foreign jurisdiction.

The temporary regulations generally apply to acquisitions occurring on or after June 7, 2012 (with a limited transition rule for transactions subject to Securities and Exchange Commission filings or binding agreements as of that date).

PwC Observation: The IRS and Treasury had expressed the possibility of addressing the substantial business activities test with a standard generally consistent with the 2006 safe harbor. Surprisingly however, the IRS and Treasury promulgated an exclusive bright-line rule rather than a safe harbor. This effectively defines "substantial" and forecloses consideration of other factors. Further, the new bright-line rule appears to have been designed so that the statutory exception will almost never apply, and in that regard does not seem consistent with congressional intent. In particular, multinational companies selling into the global market rarely have 25 percent or more of their sales to customers in any single jurisdiction. The preamble describes the reason for the change as a desire for greater "certainty" and "administrability," though recent news reports of some US company migrations may also have been a factor. As the temporary regulations have also been issued as proposed regulations, the public may comment on the new bright-line rule. The IRS and Treasury have specifically requested comments on the extent that partners of a partnership should be treated as if they were employees for purposes of the employee test.

For more information, please contact:

Carl Dubert	*(202) 414-1873*	*carl.dubert@us.pwc.com*
Oren Penn	*(202) 414-4393*	*oren.penn@us.pwc.com*
Mike DiFronzo	*(202) 312-7613*	*michael.a.difronzo@us.pwc.com*
David Sotos	*(202) 414-4322*	*david.sotos@us.pwc.com*
Ron Bordeaux	*(202) 414-1774*	*ronald.a.bordeaux@us.pwc.com*
Sean Mullaney	*(202) 346-5098*	*sean.w.mullaney@us.pwc.com*