Final Section 7874 regulations on substantial business activities in a foreign country

June 8, 2015

In brief

On June 3, 2015, the IRS and Treasury issued final regulations under Section 7874 (TD 9720) for determining when an expanded affiliated group (EAG) will be considered to have substantial business activities in a foreign country. The final regulations adopt, with certain modifications, the temporary regulations issued in 2012 and retain the bright-line rule for determining substantial business activities in a foreign country.

In detail

Background

Under Section 7874, if a foreign corporation acquires substantially all of the properties of a domestic corporation or a partnership, and, by reason of their equity interest in the domestic entity, the shareholders or partners receive at least 80% 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%, but less than 80%, 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 net operating losses 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.

2006 and 2009 temporary regulations

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 10% of its employees, assets, and sales were in a foreign jurisdiction (the 2006 Safe Harbor). The 2009 regulations removed the 2006 Safe Harbor as well as all of the examples applying the facts and circumstances test.

2012 temporary regulations

The 2012 temporary regulations replaced the facts and circumstances test with a bright-line rule. Specifically, under the 2012 temporary regulations, an EAG was considered to have substantial business activities in a foreign jurisdiction only if 25% of its employees, assets, and gross income were in that jurisdiction. The 2012 temporary regulations

further provided that if one or more members of the EAG held, in the aggregate, more than 50% 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.

Key observations in the final regulations

Bright-line rule

The final regulations retain the 25% bright-line rule provided in the 2012 temporary regulations. The IRS and Treasury rejected comments that there is insufficient support for the bright-line rule in the legislative history to Section 7874. The preamble to the final regulations provides that, because the bright-line rule under the 2012 temporary regulations is consistent with "section 7874 and its underlying policies," and is "more administrable than a facts and circumstances test," the final regulations retain the bright-line rule with certain modifications.

Comments on specific tests

The final regulations adopt the definitions of 'group employees,' 'employee compensation,' 'group assets,' and 'group income,' with certain modifications.

To meet the group employees test, the number of group employees based in the foreign jurisdiction must be at least 25% 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); and at least 25% of the compensation paid to the group's employees must have been paid to employees based in the foreign jurisdiction during the 'testing period' (which is a one-year period, ending on the applicable date). The final regulations specify that whether individuals are employees must be determined for all members of the EAG under US federal income tax principles or for all members of the EAG based on the relevant tax laws (in general, for each member of the EAG, the tax law to which that member is subject). The IRS and Treasury declined, however, to include independent contractors in certain circumstances for purposes of the test. The final regulations further provide that employee compensation is treated as incurred when it would be deductible by the employer as compensation and both the timing and amount of the deduction for all employee compensation must be determined for all group employees under US federal income tax principles or for all group employees based on the relevant tax laws.

Under the 2012 temporary regulations, the group assets test is satisfied if, on the applicable date, the value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets. The term group assets means tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the EAG, provided such property is owned (or leased from a non-member) by members of the EAG at the close of the acquisition date. In determining whether a group asset is considered to be located in the relevant foreign country, the group assets test set forth in the 2012 temporary regulations looked to whether the asset was physically present in a country: (i) at the close of the acquisition date, and (ii) for more time than in any other country during the testing period. The IRS and Treasury agreed with comments requesting relief for assets that are mobile in nature and used in a transportation activity such as a vessel, an aircraft, or a motor vehicle. Accordingly, the final regulations provide that such mobile assets do not have to be physically present in the relevant country at the close of the acquisition date, and need only be physically present in such country for more time than in any other country during the testing period to be considered present in the relevant foreign country.

To meet the group income test, at least 25% 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 final regulations provide that group income must be determined consistently for all members of the EAG using either US federal income tax principles or relevant financial statements, in general, defined as financial statements prepared in accordance with US Generally Accepted Accounting Principles (US GAAP) or International Financing Reporting Standards (IFRS).

Determining the members of the EAG

The 2012 temporary regulations provide that the EAG that includes the foreign acquiring corporation is determined as of the close of the acquisition date. The final regulations clarify that an entity that is not a member of the EAG on the acquisition date is not a member of the EAG, even if the entity would have qualified as a member of the EAG at some earlier point during the testing period. The disposition of all assets of an entity may or may not cause it to cease to be a member of the EAG depending on whether the entity remains in existence on the acquisition date.

Furthermore, consistent with the requirement under Section 7874(a)(2)(B) to take into account all

events that occur "pursuant to a plan (or a series of related transactions)," for purposes of determining whether an entity is a surrogate foreign corporation, the final regulations clarify that members of the EAG are determined by taking into account all transactions related to the acquisition, even if they occur after the acquisition date. This clarification is consistent with the rule provided in Notice 2014-52, which provides that all transactions related to an acquisition must be taken into account for purposes of determining members of an EAG, a US-parented group, and a foreign-parented group.

Treatment of partnerships

Under the 2012 temporary regulations, for purposes of the substantial business activities test, a partnership is treated as a corporation that is a member of an EAG if, in the aggregate, more than 50% (by value) of its interests are owned by one or more members of the EAG (deemed corporation rule). The final regulations add a look-through rule, whereby in determining which corporations are members of the EAG, each partner in a partnership is treated as holding its proportionate share of the stock held by the partnership. The final rules further coordinate the deemed corporation rule with the new look-through rule by providing that the look-through rule applies first without regard to the deemed corporation rule. As a result, the look-through rule applies only to determine whether an entity that is actually a corporation for US income tax purposes is a member of the EAG. Once those corporate entities are identified, the deemed corporation rule applies to treat partnerships in which those corporate entities are partners as corporations that are members of the EAG.

Anti-abuse rule

Finally, the anti-abuse rule set forth in the 2012 temporary regulations is revised to exclude from both the numerator and the denominator, for purposes of the 25% group employees, group assets, and group income tests, certain items associated with a transfer of property to an EAG that are disregarded under Section 7874(c)(4).

Effective date

The final regulations apply to acquisitions completed on or after June 3, 2015 and are effective as of June 4, 2015, the date the final regulations were published in the Federal Register.

The takeaway

The IRS and Treasury retained the bright-line rule set forth in the 2012 temporary regulations for determining substantial business activities in a foreign country, which 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% or more of their sales to customers in any single jurisdiction. Nevertheless, the IRS and Treasury rejected comments that there is insufficient support for the bright-line rule in the legislative history and concluded that the bright-line rule is consistent with Section 7874 and its underlying policies. While the preamble to the final regulations provides that the bright-line rule has proven more administrable than a facts-and-circumstances test and has the benefit of providing certainty in applying Section 7874 to particular transactions, retaining the bright-line rule is likely a sign that the US government is continuing to crack down on US company migrations.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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