PAULA LEVY is a Partner in Baker McKenzie's Palo Alto office. **STEWART LIPELES** is a Partner in Baker McKenzie's Palo Alto office. **ETHAN KROLL** is a Partner in Baker McKenzie's Los Angeles office. **JULIA SKUBIS WEBER** is a Partner in Baker McKenzie's Chicago office.

International Tax Watch

Code Sec. 7874 Is Harming Start-Ups, Squashing Deals, and Deterring Investment

By Paula Levy, Stewart Lipeles, Ethan Kroll, and Julia Skubis Weber

In 2004, Congress enacted Code Sec. 7874 as part of the American Jobs Creation Act. Code Sec. 7874 was a response to a wave of corporate inversion transactions in the preceding decade.[1] Since then, Congress and Treasury have continued to expand the scope of the U.S. anti-inversion rules through statutory changes and regulations. Recent legislative proposals to tighten the rules even further show that Congress remains concerned. The changes to date have generally been effective in preventing the types of inversion transactions that concerned Congress. Unfortunately, they have also had a considerable impact on many routine, non-tax motivated business transactions. In this column, we discuss how Code Sec. 7874 potentially creates traps for smaller early-stage companies, deters foreign investment, and requires companies to spend large amounts of time and resources on tax advice for transactions that do not raise the policy concerns Congress intended to address. We then suggest some potential approaches to changing Code Sec. 7874 to alleviate these problems.

Overview of Code Sec. 7874

Transactions Subject to Code Sec. 7874

Code Sec. 7874 potentially applies when a foreign corporation acquires, directly or indirectly, "substantially all" of the assets of a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership (a "domestic entity acquisition"). A domestic entity acquisition can include either an asset acquisition or a stock acquisition.[2] For the domestic entity acquisition to trigger Code Sec. 7874, it must satisfy two requirements. First, after the acquisition, the former owners of the domestic corporation or partnership must own at least 60% of the stock, by vote or value, of the acquiring foreign corporation by reason of their former ownership in the domestic entity.[3] We refer to the percentage of stock the former owners of the domestic corporation or partnership own due to their ownership in the domestic entity as the "ownership percentage" or, if expressed as a fraction, the "ownership fraction." Second, after the acquisition, the "expanded affiliated group," which includes the acquiring foreign corporation, must not have "substantial business activities" in the foreign country in which the foreign corporation is organized, as compared to the total business activities of the group.[4] Broadly speaking, an "expanded affiliated group" refers to one or more chains of corporations connected by more than 50% ownership under a common parent.[5]

Behind the seemingly simple basic requirements are additional statutory and regulatory rules of dizzying complexity. A full discussion of those rules is beyond the scope of this column, but we will highlight a few of the rules affecting the calculation of the ownership percentage. Some of these rules impute stock of the acquiring foreign corporation that does not actually exist to the former domestic entity shareholders. In particular, options and similar rights are treated as outstanding stock.[6] In addition, if the domestic entity has made certain distributions in the prior 36 months that are treated as "non-ordinary course distributions" under a bright-line, formulaic approach in the regulations, additional stock in the acquiring foreign corporation can be imputed to the former domestic entity shareholders to reflect the value of these distributions.[7] Conversely, several rules in the regulations disregard stock in the acquiring foreign corporation that other shareholders actually own. For example, stock of the foreign acquiring corporation that is issued in a related transaction in exchange for cash or marketable securities, or in certain other related transactions, can be disregarded.[8] Some or all of the pre-existing stock of the acquiring foreign corporation can also be disregarded if more than half of the property of the foreign acquiring corporation and its subsidiaries (excluding the acquired domestic entity and its subsidiaries) consists of cash, marketable securities, or certain other assets.[9] Stock of the acquiring foreign corporation can also be disregarded in situations where the foreign corporation has previously acquired another U.S. entity,[10] or where the foreign corporation is acquiring both the domestic entity and another foreign entity that is located in a different jurisdiction as part of the same plan.[11]

Overlaying all of these rules is a broadly worded anti-abuse rule in Code Sec. 7874(c)(4), which allows the Internal Revenue Service ("IRS") to disregard any "transfer of properties or liabilities" if the transfer is "part of a plan a principal purpose of which is to avoid the purposes of" Code Sec. 7874.

The combined effect of these rules is that the "ownership percentage," as computed under the regulations, often bears no relation to the economic reality of the transaction. Because the rules can create fictitious shares while also disregarding actual shares, the former domestic entity shareholders can even, in some cases, be deemed to exceed the ownership percentage even if they actually own no stock (or only minimal stock) in the acquiring foreign corporation.[12] Although this result seems inappropriate and contrary to the policy behind Code Sec. 7874, it arises all too often.

It is also important to recognize that the regulations effectively write the substantial business activities exception out of the statute.[13] The regulations make it extraordinarily unlikely, as a practical matter, that a multinational enterprise will be able to show it has substantial business activities in any country outside of the United States. Under the regulations, business activities in a jurisdiction are "substantial" only if at least 25% of the corporate group's employees (by headcount and compensation), tangible assets, and gross income from transactions in the ordinary course of business with unrelated customers are located or arise in that same jurisdiction, and the acquiring foreign corporation is a tax resident of that jurisdiction.[14] The difficulty of satisfying this standard is illustrated in the Start-Up example, below.

Consequences of Triggering Code Sec. 7874

The consequences of triggering Code Sec. 7874 are severe. If the ownership percentage is at least 60% (but less than 80%), the U.S. entities within the corporate group are not able to use net operating losses, tax credits, or other attributes to offset the tax costs of certain transfers or licenses of property within a 10-year period.[15] Certain insiders are subject to an excise tax on any stock-based compensation they hold within six months before or after the domestic entity acquisition.[16] The Tax Cuts and Jobs Act of 2017 (the "TCJA"), as well as various regulations introduced since 2004, creates additional adverse consequences. Payments that the U.S. entities in the group make to foreign related parties for the cost of goods sold, which would otherwise not be subject to the base erosion and anti-abuse tax ("BEAT") under Code Sec. 59A, are treated as subject to the tax.[17] The transition tax under Code Sec. 965 is retroactively increased to 35%.[18] Dividends that the acquiring corporation pays to individual shareholders are taxed at ordinary income rates, and are not eligible for reduced U.S. tax rates for qualified dividends.[19] Special rules under Code Sec. 956 make it more difficult for foreign subsidiaries of the domestic entity to make loans to the ultimate foreign parent,[20] and additional rules under various Code sections make any future planning to move assets out from under the domestic entity more difficult and costly.

Most onerous of all, if the ownership percentage is at least 80%, the acquiring foreign corporation is treated as a domestic corporation for all purposes under the Code, thus subjecting all of the corporation's income to U.S. tax and all of the income of its non-U.S. subsidiaries to the subpart F and GILTI regimes.[21] This treatment continues for all future tax years, even if the former domestic entity shareholders cease to own any stock in the acquiring foreign corporation, and even if the acquiring foreign corporation disposes of the domestic entity (or its assets) that it acquired. Code Sec. 7874 expressly provides that treaties cannot override this result.[22]

Purposes of Code Sec. 7874

Congress enacted Code Sec. 7874 in the wake of an increase in inversion transactions starting in the 1990s. Congress was concerned primarily with inversion transactions that take place within a single corporate group, *i.e.*, transactions in which U.S. corporations "reincorporate in foreign jurisdictions and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation."[23] The examples in the legislative history refer to a reverse subsidiary merger where the U.S. corporation forms a foreign corporation with a U.S. merger subsidiary, and then merges into the latter, or to a simple merger of a U.S. corporation into a new foreign corporation. In both examples, the former shareholders of the U.S. corporation own 100% of the new foreign parent entity. The legislative history also indicates that Congress focused on transactions with "little or no non-tax effect or purpose," after which U.S. corporations "continue to conduct business in the same manner as they did prior to the inversion" and the acquiring foreign entities have only "a minimal presence in a foreign country of incorporation."[24] Congress viewed these transactions as "a means of avoiding U.S. tax."[25]

Nothing in the legislative history suggests that Congress was concerned with strategic business transactions that have a non-tax purpose, such as third-party acquisitions. Nevertheless, the statute clearly encompasses third-party business combinations, and Treasury has continued to issue regulations that expand the scope of Code Sec. 7874.

Potential Traps and Overreach

Code Sec. 7874 can create serious issues for smaller companies at an early stage of development, particularly those that do not have the resources to obtain sophisticated international tax advice at the outset. Consider the following examples.

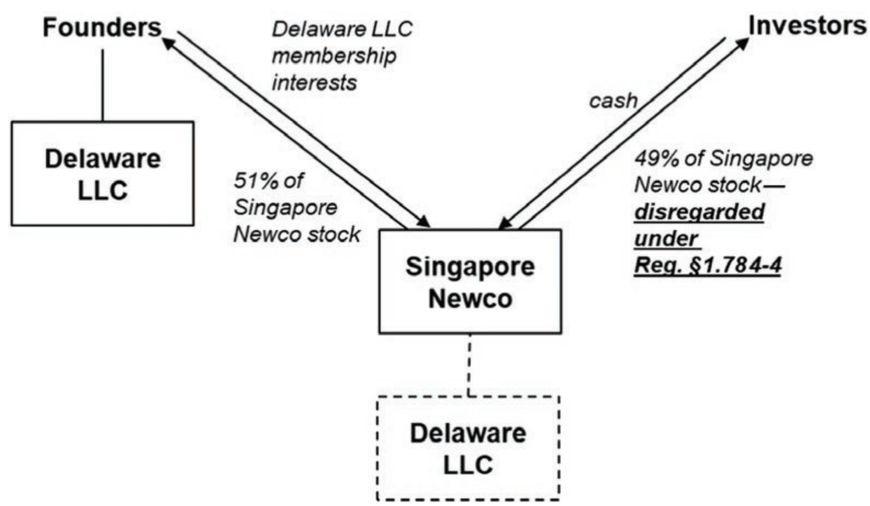
The Start-Up

Two students, from China and Taiwan, meet at an American university. Shortly after graduation, they found a technology start-up that is heavily focused on the Asia Pacific market. They have little or no budget, and based on advice from various free legal resources, as well as informal discussions with some contacts at venture capital funds, they form a Delaware LLC. The start-up is a success and develops valuable intellectual property and a broad multinational customer base worldwide, particularly across the Asia Pacific region. In the meantime, both of the founders have moved back to their home countries and the company has hired additional employees in several locations across Asia. At this stage, the company has no business presence in the United States apart from one marketing employee and U.S. customers that make up less than 10% of the start-up's customer base. The founders are now seeking further investment to let them expand their business, including hiring the best talent wherever it is located (including U.S. and non-U.S. software engineers, marketing personnel, and others).

The founders have some success in soliciting investments. Their best prospects are with private equity funds and a couple of "angel" investors located in the Asia Pacific region. These investors are collectively willing to invest a substantial amount on favorable terms in exchange for 49% of the stock of the company. These prospective investors strongly advise the founders to set up a new local entity, ideally in Singapore, as the investment vehicle ("Singapore Newco"). The investors are much more comfortable investing in Singapore entities directly due to Singapore's business-friendly environment and the investors' familiarity with the legal and financial systems there. Given that the company already has some operations and employees in Singapore, and Singapore is in close proximity to the vast majority of the company's other employees and its customer base, the founders decide that this is the best choice. They propose to transfer the membership interests in the Delaware LLC to Singapore Newco in exchange for Singapore Newco stock (*see* Figure 1).

Unfortunately, Code Sec. 7874 prevents the company from re-incorporating outside the United States. The transaction would be a "domestic entity acquisition" because the Delaware LLC owns valuable business assets that Singapore Newco will indirectly acquire. The company

FIGURE 1.



is unable to show that the group would have "substantial business activities" in Singapore because, while the majority of its headcount is concentrated in a couple of locations in Asia (and it has few tangible assets anywhere apart from laptops and office equipment), its customer base is spread across the region and the United States, with no country having more than a 20% share of customer revenues. Finally, even though the existing owners of the Delaware LLC will own only 51% of the company after the transaction, for Code Sec. 7874 purposes their ownership percentage is treated as 100% due to the so-called "public offering" rule in Reg. §1.7874-4. The "public offering" rule disregards any Singapore Newco shares that the new investors receive in exchange for cash or other passive assets such as marketable securities.

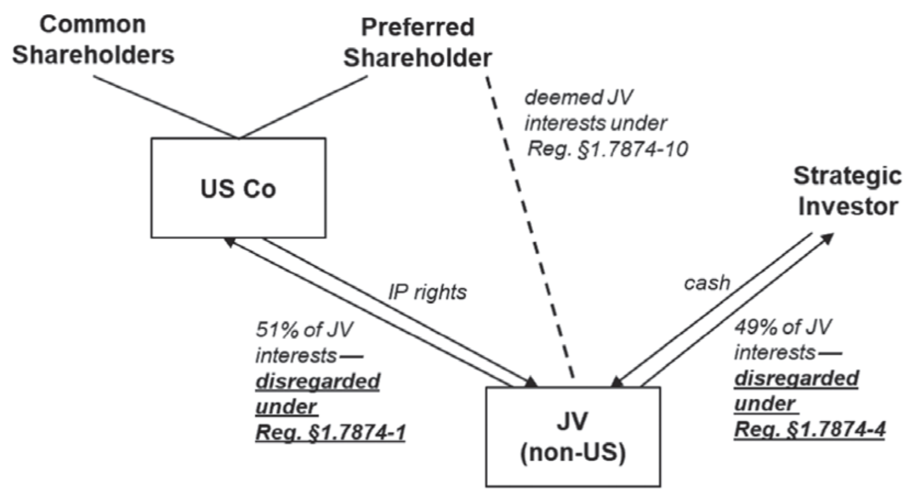
The result is that if the founders proceed with their plan, the Singapore Newco will be treated as a U.S. corporation and a U.S. tax resident for all future tax years. Even if the company does not end up paying incremental U.S. tax (due to the ability to credit any Singapore taxes), it will need to file U.S. tax returns. Moreover, because the United States does not have a tax treaty with Singapore, any dividends to Singaporean shareholders (including some of the new investors, as well as any employee shareholders who are Singapore residents) will be subject to 30% dividend withholding tax. Faced with this complexity and additional cost, both the investors and the founders walk away from the plan.

The Joint Venture

US Co is a medical device company making life-saving products for the United States and worldwide markets. Most of US Co's research and development takes place in the United States, where the company employs a growing workforce. US Co's manufacturing also takes place in the United States. The company is still in an early stage and is generating only a modest amount of revenue, but expects that in the long term more than 80% of its revenues will come from outside the United States. In particular, the company has plans to begin expanding into the Latin America market, where it expects demand for its product to be high. Because US Co's product is highly regulated, it needs more resources to be able to exploit the product in Latin America. A strategic investor in Mexico approaches US Co about a potential joint venture. The strategic investor will contribute cash in exchange for 49% of the interests in the joint venture. US Co will contribute an exclusive, perpetual license to exploit its products in the Latin America market in exchange for the remaining 51% of the interests in the joint venture. Anticipating a possible initial public offering ("IPO") of the joint venture in the near future, but also wishing to accommodate the strategic investor's desire not to invest through a U.S. vehicle (as well as to simplify regulatory issues), the parties decide to make the joint venture vehicle a non-U.S. company that is treated as a corporation for U.S. tax purposes. Going forward, US Co will continue to provide research and development services to the joint venture and to manufacture the products on a contract manufacturing basis (*see* Figure 2).

Depending on the value of the Latin America rights, and on the approach to defining "substantially all" (there is no guidance on this point in the Code Sec. 7874

FIGURE 2.



regulations), could the assets that US Co contributes potentially constitute "substantially all" of its assets, resulting in a domestic entity acquisition? The regulations do not provide a standard for "substantially all" in the context of Code Sec. 7874. Because the potential consequences of Code Sec. 7874 can be so draconian, the company concludes that it cannot take any risk that it will be subject to Code Sec. 7874. Assume that the expanded affiliated group will not have "substantial business activities" in the joint venture's country of incorporation due to the dispersed nature of its workforce and customers. This leaves the key question of whether the ownership percentage is over 60%.

At first glance, this transaction seems well out of the danger zone. The shareholders of US Co do not receive any stock in the joint venture but continue to own their interests through a U.S. corporation. This initial impression is misleading. The shares in the joint venture that US Co receives are disregarded under the expanded affiliated group rules of Reg. §1.7874-1. The shares that the strategic investor receives are disregarded under the public offering rule of Reg. §1.7874-4. So far, this should not be an issue. Suppose, however, that US Co issued some preferred stock last year, representing 7% of its total outstanding share capital, to an outside investor as part of a financing transaction, and has just made its first annual payment of a dividend on that stock. Under the bright-line rules of Reg. §1.7874-10, this transaction is a non-ordinary course distribution. As a result, shares in the joint venture are imputed to the preferred shareholders of US Co.[26] There is a *de minimis* exception to the non-ordinary course distributions rule, but it does not provide relief here. Because these deemed shares are the only shares taken into account for the purpose of calculating the ownership percentage, the ownership percentage is deemed to be 100%. Faced with the prospect of the joint venture being subject to U.S. tax as if it were a U.S. corporation, and potentially withholding tax on dividends to the strategic investor, the strategic investor withdraws from the deal.

The Failed Acquisition

Canada Co is looking to acquire the smaller US Co. The consideration for the transaction is still being negotiated, but will likely involve a mix of stock and cash. Both companies are small and are highly fee-sensitive. Canada Co has heard from its advisers that the U.S. anti-inversion rules under Code Sec. 7874 are highly complex and will require significant due diligence on the part of both companies to investigate their capital structure, equity award plans, assets, dividend history, acquisition history, location of assets and employees, location of customer revenues, and other key facts. The fee estimate from Canada Co's U.S. tax advisers to fully analyze this issue alone, and to provide an opinion on the issue, easily exceeds Canada Co's budget for completing the entire transaction. Moreover, as noted above, Congress remains concerned about inversions, and members of Congress continue to propose anti-inversion legislation. Accordingly, the parties are concerned that the rules may change before closing. Canada Co considers the potential costs to both it and its shareholders in the event the transaction is treated as an inversion and concludes that the magnitude of the risk is too great to proceed without an opinion from reputable tax counsel. Faced with this hurdle, Canada Co abandons the negotiation.

Tailoring Code Sec. 7874 to Limit the Burden on Smaller Companies and Support Foreign Investment

As the above examples show, Code Sec. 7874 potentially applies to many legitimate business transactions that are not motivated by tax avoidance and that do not implicate the policy concerns that led Congress to enact Code Sec. 7874. Code Sec. 7874 can be particularly challenging for small companies. These companies may not have received sophisticated legal and tax advice when setting up their companies initially. Moreover, even for a transaction that ultimately falls outside the scope of Code Sec. 7874, the amount of diligence and legal analysis required to reach this conclusion can be prohibitively expensive and burdensome, requiring resources that these companies may not have. The regulations compound this problem by introducing ever more complex rules that are highly fact-dependent and leave no room for arguments based on a lack of tax avoidance purpose. To make matters worse, the rules for calculating the ownership fraction are counterintuitive and thus create traps for the unwary. The regulations require an extremely complex assessment of each transaction, and may sometimes require companies to make changes to the structure of a transaction or the form of the consideration to avoid a technical footfault.

The same problems may deter foreign companies and investors from pursuing investments in or joint ventures with U.S. companies. They may also ultimately limit the attractiveness of the United States as a jurisdiction for start-up companies.

There are a number of ways in which Code Sec. 7874 and the regulations might be tailored to relieve some of these burdens, while still capturing the tax-motivated transactions that concern Congress. One approach would be simply to exempt companies below a certain size and/or start-up companies that have been in existence for only a couple of years. Small companies are significantly less likely to undertake an inversion as a tax planning maneuver, and are much more likely to be looking to restructure or migrate for purely business reasons. Moreover, the fact that a company did not receive international tax advice initially (or perhaps incorporated in the United States in the hope of attracting potential investors, or because practical concerns and getting off the ground were their most pressing concerns at the time) should not trap that company within the U.S. tax net forever if the company has no real nexus with the United States.

A complete exemption for small or start-up companies is preferable, because it eliminates the need for smaller companies to seek costly and detailed U.S. tax advice for an otherwise fairly simple transaction. Treasury may feel that it needs Congress to act to implement any solution along these lines, which seems unlikely in the face of continued concern about inversions. That said, Congress and Treasury have created exceptions for smaller companies and new businesses in other situations. For example, the base erosion and anti-abuse tax applies only to companies with gross receipts of at least $500 million.[27] The passive foreign investment company ("PFIC") rules include an exception for start-up companies in the first year that they generate gross income, assuming they do not become PFICs within the two subsequent years.[28] In the Code Sec. 355 context, while historically companies have needed to show that they have been generating income to satisfy the active business requirement, Treasury has acknowledged that start-up companies may not generate revenue for several years, and has relaxed the requirements pending further study.[29]

Another solution, which Treasury could undertake unilaterally, would be to adopt additional *de minimis* exceptions to certain regulations. For example, distributions below a certain threshold (whether by dollar value or by percentage of the company's assets) could be exempted from the non-ordinary course distributions rule. Companies below a certain size could be exempted from some of the other rules as well.

In addition, Treasury should consider relaxing the substantial business activities test. As noted above, the current version of the substantial business activities test makes it almost impossible for any company with a true international presence to satisfy the test. Whether the company's activities in its country of incorporation are substantial should be viewed in light of all the facts and circumstances, taking into account the global economic environment. Treasury should consider taking into account, for example, how the group's activities in the relevant country compare to those in the United States as well as other countries, and whether the company's activities overall are broadly dispersed or whether its activities are heavily concentrated in a jurisdiction other than the relevant country being tested. In addition, expecting a company to satisfy all three prongs of the test in all cases is not realistic in today's global economy, where a company's workforce may not necessarily be located in the same country or even region as its customers and/or its suppliers. It is not uncommon, for instance, for a company to conduct most of its research and development in the United States, even though its customers and suppliers, along with the business operations that interface with and support each, are in Asia. Similarly, a company could easily have a diverse worldwide customer base, making it impossible for the company to meet the substantial business activities test anywhere. Where the company has a real economic connection to its country of incorporation, and minimal activities in the United States, it should be able to rely on a reasonable version of the substantial business activities test.

A final approach to consider would be to apply a principal purpose test in lieu of, or as an additional prerequisite to, some of the bright-line rules, or to reframe these rules as creating rebuttable presumptions that can be overcome by a showing of no tax avoidance purpose. This change would be more consistent with the language of the statute, as several of the current rules (such as the non-ordinary course distributions rule) rely on Code Sec. 7874(c)(4)'s anti-abuse rule for authority but do not incorporate its principal purpose standard. This change would not really increase taxpayer uncertainty because taxpayers with concerns about the principal purpose standard could simply continue to apply all of the ownership percentage rules in their current form to be conservative. For other taxpayers, it will be clear that tax was not a principal purpose for the transaction and they will be able to simplify the analysis considerably. It is also worth noting that Code Sec. 7874(c)(4) already potentially applies to any transfer that involves the taxpayer regardless of whether it is caught by one of the specific rules in the regulations, so taxpayers already must evaluate their purpose in applying Code Sec. 7874.

Any of these approaches would bring welcome relief to small companies struggling to manage Code Sec. 7874 issues and better support start-up companies and foreign investment into the United States, while continuing to curb significant tax-motivated transactions.

ENDNOTES

1. *See* Congressional Budget Office, Congress of the United States, *An Analysis of Corporate Inversions* (2017), p. 6.
2. Code Sec. 7874(a)(2)(B)(i); Reg. §1.7874-12(a)(5).
3. Code Sec. 7874(a)(2)(B)(ii).
4. Code Sec. 7874(a)(2)(B)(iii), (c)(1).
5. Code Sec. 7874(c)(1).
6. Reg. §1.7874-2(h).
7. Reg. §1.7874-10.
8. Reg. §1.7874-4.
9. Reg. §1.7874-7.
10. Reg. §1.7874-8.
11. Reg. §1.7874-9.
12. For example, if the former domestic entity shareholders receive "in-the-money" options or similar rights in the acquiring foreign corporation, these rights may be treated as stock (Reg. §1.7874-2(h)). Moreover, shares may be attributed to the former domestic entity shareholders under the "non-ordinary course distributions" rule of Reg. §1.7874-10, regardless of whether those shareholders actually receive any stock or other equity in the acquiring foreign corporation. Although there is a *de minimis* exception, that exception will not universally apply. For instance, larger shareholders may not qualify for the *de minimis* exception if they own, or are deemed to own by attribution, stock in another entity in the group (Reg. §1.7874-10(d)). These issues are magnified when shares that other shareholders own are disregarded. The Joint Venture example, below, provides an illustration.
13. *See* Stewart R. Lipeles, John D. McDonald and Paula R. Levy, *Code Sec. 7874 Regulations; Third Time's the Charm?*, Taxes (Nov. 2012).
14. Reg. §1.7874-3.
15. Code Sec. 7874(a)(1), (e)(1).
16. Code Sec. 4985.
17. Code Sec. 59A(d)(4).
18. Code Sec. 965(l).
19. Code Sec. 1(h)(11)(C)(iii).
20. Reg. §1.956-2(a)(4).
21. Code Sec. 7874(b).
22. Code Sec. 7874(f). Moreover, once the foreign corporation is recharacterized as a U.S. corporation, other issues may arise in applying tax treaties. We are not aware of any authorities addressing whether a company that is treated as a U.S. taxpayer under this rule qualifies as a U.S. resident for the purposes of claiming treaty benefits. Most U.S. authorities define residency by reference to domicile, residence, citizenship, place of management, place of incorporation, or "other criterion of a similar nature," which could allow room for inverted companies to qualify. Even if the company is a U.S. tax resident, certain treaties may deny treaty benefits to dual residents. *See* Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (2003), as amended by the Protocol signed January 24, 2013, Art. 4(4).
23. H.R. Rep. No. 108-755, at 568.
24. S. Rep. No. 108-192, at 142; S. Rep. No. 108-54, at 95.
25. S. Rep. No. 108-192, at 142; S. Rep. No. 108-54, at 95.
26. Reg. §1.7874-10(b), (h).
27. Code Sec. 59A(e)(1)(B).
28. Code Sec. 1298(b)(2).
29. *See* IRS Office of Chief Counsel Statement Regarding the Active Trade or Business Requirement for Section 355 Distributions (Sept. 25, 2018), *www.irs.gov/newsroom/irs-statement-regarding-the-active-trade-or-business-requirement-for-section-355-distributions*; Rev. Rul. 2019-9, IRB 2019-14, 925; *see also* Reg. §1.355-3(b)(2)(ii) (the activities constituting a business "ordinarily must include the collection of income").