Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Associate Area Counsel
(Large Business & International)

from: Chief, Branch 4
Office of Associate Chief Counsel
(International)

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subject: Application of Section 7874

This Chief Counsel Advice responds to your request for assistance. In accordance with section 6110(k)(3), this advice may not be used or cited as precedent.

New X	=
Old X	=
Appraiser	=
Taxpayer's Tax Counsel	=
Taxpayer's Accounting Firm	=
Lenders Subgroup	=
Agreement 1	=
Agreement 2	=
Agreement 3	=
Memorandum 1	=
Country 1	=
Country 2	=
Country 3	=
Country 4	=

Country 5 =
Country 6 =
State 1 =
State 2 =
City 1 =
City 2 =
City 3 =
City 4 =
Region A =
Region B =
Region C =
Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =
Year 3
Year 4
Year 5
Year 6
Year 7
Year 8
Year 9
B =
P =
Q =
C =
E =

X =

$.a =

b =

c =

d =

e =

f =

g =

ISSUE

Whether New X is a surrogate foreign corporation within the meaning of section 7874(a)(2)(B) and, if so, whether it is treated for purposes of the Internal Revenue Code ("Code") as a domestic corporation pursuant to section 7874(b).

CONCLUSION

New X is a surrogate foreign corporation within the meaning of section 7874(a)(2)(B) and is treated for purposes of the Code as a domestic corporation pursuant to section 7874(b).

FACTS

I. Background

In Year 2, organized its many separate operations into a subsidiary, which was later renamed X Corporation ("X" or "Old X"). X became an independent publicly traded domestic corporation in Year 5 .

After the , X was a . .

In Year 7, X . (the initial " ") extended financing to X pursuant to the and other relevant agreements. After being refinanced in , the consisted of of secured loans: . The notes had first liens on significant assets of X; the notes had a second lien on the same assets.

. The notes held by the were traded over time, such that the identity of the varied.

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II.

and ("P and Q"), ,
acquired more than 50 percent of the of the
, and varying percentages of the
. The amounts of
the notes held by P and Q over the period varied; however, P
and Q always held more than 50 percent of the of the
after , . In addition, the holders of the
collectively held approximately 50 percent of the
of the *.*

[1]

X was reorganized ("
").

III. Payments to

Under the Agreement 1, the Agreement 2, and the other referenced agreements, the
holders of the were entitled to be paid
[2] In addition, the holders of the
were entitled to receive
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IV. Funding of Payments to

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. First, X would sell its division and sites to B in exchange for $b .

Second, as described in detail below, , a formed under the laws of ("Country 1") treated as a for Federal tax purposes ("New X" or "Taxpayer"), was formed. New X acquired other assets from Old X for a stated amount of $c , and the assumption of certain Old X liabilities.

V. Formation of New X

On , , New X was formed as a Country 1 , to acquire Old X's assets.[3] The Taxpayer intended that New X be treated as a for U.S. tax purposes. New X was to issue (together, the "Equity Securities"). contributed $ of cash to New X in exchange for all the . The were to be issued for a stated purchase price of $d

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The represented a , , and percent interest, respectively, in New X.[4]

The holders of the and were committed to purchase $ of of New X. The holders of the would also be $. New X never issued the .

[3] Originally a different , , a State 1 , was formed by P & Q to acquire the X assets, and to conduct the X business. It was subsequently determined, however, that a Country 1 should be used, so P & Q caused to assign its rights under the contracts to New X.

[4] These percentages are based on the . Under the interests represented by the Equity Securities vary based upon the liquidation value of the company.

contributed $ cash to New X in exchange for all of the . retained the , and transferred the to the (the "C") in exchange for the C agreeing to waive and release its claims against and X (and X affiliates). The were issued to the (including P and Q and a subgroup of for a stated purchase price of $d .

According to the Taxpayer, New X established the following initial for the Equity Securities following the closing of the :

- $ in the aggregate for the holders of the Equity Securities;
- $ in the aggregate for the holders of the Equity Securities; and
- $ in the aggregate for the holders of the Equity Securities.

According to the Taxpayer, the Equity Securities issued initially carried a of $,

. and the other holders of the Equity Securities (including P and Q and the), were, according to the Taxpayer, credited with $ and $, respectively, of

It is not clear on what basis the $ was allocated between the Equity Securities ($) and the Equity Securities ($). However, all the holders of Equity Securities, including P and Q, the

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VI. Acquisition of New X Equity Securities

Under the Agreement 3 (the " "), one of the contracts upon which the was dependent, P and Q committed to purchase from New X the Equity Securities and $e of notes. Under the Agreement 3, P and Q reserved the right, and indeed intended, to syndicate all or a portion of their obligation to purchase the Equity Securities and notes. Prior to the , the were trading at an average of $.[5]

[5] The average trading value was for the period between , and , .

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Approximately days after , P and Q offered the the right to purchase, in the aggregate, percent of the Equity Securities, and percent of the notes that they committed to purchase (the). P and Q and their related entities were among to which the offer was made. In order to acquire the Equity Securities, a also had to agree to). The of Equity Securities and notes were allocated to the based upon . The individual could then subscribe to representing the proportionate amount of

In addition, according to the Taxpayer, prior to and in anticipation of P and Q entering into the Agreement 3, whereby P and Q committed to purchase all the Equity Securities of New X, P and Q offered ,[6] the right to purchase a portion of the remaining g percent of the Equity Securities, which it would not offer in the [7] The were also offered the right to purchase the Equity Securities that were to be offered in the , but not acquired.

holding percent of the accepted the offer, and purchased Equity Securities. The , other than funds managed by P and Q, acquired approximately percent of the Equity Securities, in excess of the amount of Equity Securities they could have purchased by participating in the .

In executing the transaction, the under the Agreement offset all amounts due to the individual by the amounts that the individual owed for the Equity Securities and notes. The paid the individual the net amounts due them , net of the amounts that the individual owed the for purchase of the

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[6] It appears that in certain instances related to the actually purchased the Equity Securities, so that not every purchaser had actually owned . When this memorandum refers to the , depending on the context, it may refer to either the entities that were offered the Equity Securities, or the that actually purchased the securities.

[7] It appears, however, that the did not have a right of first refusal with respect to the remaining g percent of the securities, as they appear in fact to have only been able to purchase interests not already syndicated to P and Q and other .

Equity Securities. The Equity Securities were then issued by New X to the individual .

VII. Properties Held by Old X

In connection with the , the properties held by Old X were, in effect, categorized into three classes: (1) properties sold to B ("B Properties"); (2) properties acquired by New X ("Acquired Properties"); and (3) (" Properties").

A. <u>B Properties</u>

As part of the ,. B agreed to purchase the B Properties, which consisted of Old X's business and . Although the stated amount to be paid for the B Properties was $ plus the assumption of certain liabilities, the amount of cash actually paid for the B Properties was reduced to $b .

Notwithstanding the purchase price of $b , B reported the B Properties as having a net value of $ on its financial statements as of , .[8] In addition, Appraiser, Inc. ("Appraiser"), an outside valuation expert retained by the Service, determined the value of the B Properties at the time of the sale to B to be $

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B. <u>Acquired Properties</u>

The Acquired Properties consisted of all of the properties held by Old X (including a portion of the proceeds from the sale of the B Properties), other than the Properties.

Although, as noted above, New X transferred only $c of cash to Old X and assumed certain Old X liabilities for the Acquired Properties, this amount did not reflect the value of the Acquired Properties. For fresh-start accounting purposes, and in connection with the , Taxpayer's Accounting Firm valued the Acquired Properties (other than the portion of the proceeds from the sale of the B

[8] The value of the gross assets was reported at $, comprised primarily of accounts and notes receivable, inventories and property, plant and equipment. The amount of the liabilities was reported at $, comprised primarily of accounts payable, accrued expenses, short term debt and other liabilities. In , B sold the B Properties to a third party for $, plus assumed liabilities. B recorded a $ gain on the sale for financial accounting purposes.

Properties). The Taxpayer's Accounting Firm valuation determined that the net assets of New X, as a going concern, had a value of $.[9] After adding assumed liabilities and various other liabilities to this net asset value, the value of New X's gross assets equaled $.

C. Properties

The Properties, primarily consisting of approximately sites,

. The Taxpayer represented that these assets were valued at approximately $.[10]

VIII. Business Activities of the New X EAG

A. In General

The Taxpayer, throughout its Form , describes New X as the continuation of Old X. The expanded affiliated group (within the meaning of section 7874(c)(1)) that includes New X (the "New X EAG") operated its business in countries through approximately sites. As of July of Year A, of the sites (percent) were located in Country 1.

B. Historical Conduct

, in the United States in Year 1, historically . Old X was formed in Year 2 combined its various operations into a single subsidiary. from which it was formed have since .

In Year 5, , X conducted certain activities in Country 1. X's Country 1 activities expanded in Year 6 as a result of the acquisition of the E business. After the , the New X EAG operated these Country 1 businesses.

C. Property Located in Country 1

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[9] Appraiser, Inc., an outside valuation expert retained by the Service, determined a similar enterprise value of $ (net of liabilities).

[10] Appraiser determined that the Properties had no value.

According to Taxpayer, as of Date 3, , percent of the New X EAG's total gross assets and percent of its total property, plant, and equipment were located in Country 1.[11]

The above fraction includes, in the denominator, approximately $ of cash and cash equivalents, which includes $ in cash for which the Taxpayer did not have an immediate need in working capital as of Date 3 . However, at the time of the , the Taxpayer determined that this cash was necessary in order to enable New X to continue as a . This cash, which and the contributed to New X in exchange for Equity Securities, was not held in Country 1.

According to a valuation study commissioned by X, the value of the Country 1 operations as of , was $ using the market approach; that is, by using multiples based on the stock prices of comparable publicly traded companies. After taking liabilities into account, the fair market value of the Country 1 operating entities was $. Based on this net valuation approach, the net equity value of New X's Country 1 legal entities was percent of its total equity value.[12]

D. Performance of Services in Country 1

As of Date 1, , percent of the New X EAG employees were located in Country 1. In addition, the payroll expense of the New X EAG attributable to employees located in Country 1 constituted percent of its worldwide payroll expense as of Date 1, .

E. Sales of Goods

Based on financial statements, percent of X's net sales were from goods in Country 1 for the period from , through , . For the nine-month period ending on Date 1, , sales to Country 1 customers represented percent of worldwide sales.

F. Managerial Activities

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[11] The property figure is net of accumulated depreciation.

[12] Using a similar net equity value approach, Appraiser concluded that the value of X's Country 1 entities was $ as of the , which represented percent of X's business enterprise value.

At the time of the , the New X EAG's worldwide headquarters and top management were all located in City 1, . The New X EAG maintained regional headquarters in City 2, Country 2; City 3, Country 3; and City 4, Country 4. The divisional offices for X's , of which the majority of New X's Country 1 assets were a part, were located in Country 4. Only local management overseeing Country 1 operations was located in Country 1. of the New X EAG's executives, approximately percent of its more than executives, were located in Country 1 as of Date 1, .

G. <u>Ownership of New X by Investors Resident in Country 1</u>

After the , the New X Equity Securities were owned by , the C, and the (including Q and P). Neither nor the C was resident in Country 1. The were primarily U.S. . The had investors located in various countries. Taxpayer has not provided information indicating that any holders of the Equity Securities were resident in Country 1.

H. <u>Business Activities in Country 1 Material to the Achievement of Overall Business Objectives</u>

New X is a supplier of for . Its business consists of divisions:

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The New X EAG certain in Country 1, including E and products, in various facilities located in different locations. Taxpayer asserts that the Country 1 business provides capability that contributes to New X's other businesses including its E operations. In addition, the New X EAG's Country 1 operations include developing .

According to its , the New X EAG adopted model, under which are serviced from countries, in order to reduce and increase . As of Year 9, percent of its hourly workforce was located in such countries, and percent of this workforce was temporary. Under this model, the Region A market generally was served from Region B and Region C.

New X stated in its that it expected nearly half of its future growth to be generated from markets, particularly Country 3, and accordingly, has substantially expanded its presence in markets. It stated that as of Year 9, it has operated in Country 3 for nearly years, and it employed approximately

people in Country 3, including approximately
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The offered for
needs. The offered products for
, including a E product line. The division provided a wide range of
in the following areas:

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The division provided
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The division provided
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The products that New X produced were sold to the
, all over the world.

In addition to lowering its labor costs and focusing on markets, New X's stated strategic plan was to develop focused on industry trends: ".

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IX. Aftermath of the

The Taxpayer has stated that the Equity Securities in New X were readily tradable on a secondary market (or the substantial equivalent thereof) within the meaning of section 7704(b)(2).

On , Year 9, New X redeemed the and Equity Securities for approximately $.

X. Taxpayer's Treatment of the Transaction

Based on a draft tax opinion dated [13] from its outside tax counsel, , the Taxpayer took the position that New X was not a surrogate foreign corporation within the meaning of section 7874(a)(2)(B) because the requirements in section 7874(a)(2)(B)(i) (regarding the acquisition of substantially all the properties held by Old X) and 7874(a)(2)(B)(iii) (regarding substantial business activities of the New X EAG) were not satisfied.[14]

XI. Procedural Posture

All years at issue are currently under examination.

LAW AND ANALYSIS

I. Overview

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[13] The draft tax opinion was never finalized.

[14] The draft opinion concluded that the requirement in section 7874(a)(2)(B)(ii) (regarding ownership) was satisfied as a result of stock received by the , finding that "[b]ecause the interests in X were received for cash, under Notice 2009-78's broad exclusion of cash payments for stock interests the overlapping shareholder test appears to be met."

In addition to analyzing the three requirements under section 7874(a)(2)(B) that must be satisfied for New X to be treated as a surrogate foreign corporation, certain other related issues must also be considered. Thus, after first outlining the general rules under section 7874 in section II of the LAW AND ANLYSIS section of this memorandum, Section III analyzes the effect of New X being a . Because Old X was under , . Section V applies judicial doctrines to the and their acquisition of New X Equity Securities. Sections VI, VII, and VIII analyze the "substantially all" requirement, the "ownership" requirement, and the "substantial business activities" requirement, respectively, that must be satisfied for New X to be treated as a surrogate foreign corporation. Section IX analyzes the treatment of New X as a surrogate foreign corporation to which Section 7874(b) applies.

II. Section 7874 – In General

A. Statute

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is a domestic corporation or domestic partnership with respect to which a foreign corporation is a surrogate foreign corporation, and any United States person related (within the meaning of sections 267(b) or 707(b)(1)) to such domestic corporation or domestic partnership.[15]

Section 7874(a)(2)(B) provides that a foreign corporation constitutes a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions), three conditions are satisfied.[16] First, the foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation.[17] Second, after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the "Ownership Condition").[18] Third, after the acquisition the expanded affiliated group that includes the

[15] Section 7874(a)(2)(A).

[16] Section 7874(c)(3) provides that "[i]f a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4-year period beginning on the date which is 2 years before the ownership requirements of subsection (a)(2)(B)(ii) are met, such actions shall be treated as pursuant to a plan." Section 7874(c)(4) provides that "[t]he transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [section 7874]."

[17] Section 7874(a)(2)(B)(i). Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

[18] Section 7874(a)(2)(B)(ii).

foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of such expanded affiliated group.[19]

Section 7874(c)(1) defines the term expanded affiliated group as an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

Under section 7874(c)(2), certain stock of the foreign corporation is not taken into account in determining whether the Ownership Condition is satisfied: (1) stock of the foreign corporation held by members of the expanded affiliated group that includes the foreign corporation, and (2) stock of the foreign corporation sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i).

If the foreign corporation constitutes a surrogate foreign corporation and the percentage described in section 7874(a)(2)(B)(ii) ("Ownership Fraction") is at least 60 percent, but less than 80 percent, the corporation continues to be treated as a foreign corporation for U.S. tax purposes, but the taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period in no event is less than the inversion gain (defined in section 7874(d)(2)) of the entity for the taxable year.[20] If the foreign corporation constitutes a surrogate foreign corporation and the Ownership Fraction is at least 80 percent then, notwithstanding section 7701(a)(4), it will be treated as a domestic corporation for all purposes of the Code.[21]

B. <u>Legislative History</u>

Congress enacted section 7874 in 2004 to "remove the incentive for entering into an inversion transaction," that is, a transaction in which "a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation."[22] As a result of such transactions, U.S. corporations were able to "remove income from foreign operations from the U.S. taxing jurisdiction" – for example, by having "the U.S. corporation transfer some or all of its foreign subsidiaries directly to the new foreign parent or other related foreign corporations" – and engage in "earnings stripping through payment by a U.S.

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[19] Section 7874(a)(2)(B)(iii).

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

[21] Section 7874(b).

[22] H.R. Rep. No. 548, 108th Cong., 2nd Sess. 243-44 (2004); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 2005), at 342-43.

corporation of deductible amounts such as interest … to the new foreign parent or other foreign affiliates."[23] Congress was concerned that certain inversion transactions "permit corporations and other entities" to achieve these results even though the entities would "continue to conduct business in the same manner as they did prior to the inversion."[24]

Although under prior law inversion transactions may have given "rise to immediate U.S. tax consequences at the shareholder level and/or the corporate level," [25] such consequences did not provide a sufficient deterrent to inversion transactions.[26] Accordingly, Congress determined that a new regime was needed to address these transactions, the applicability and consequences of which depend on the extent of the overlap of the former shareholders of the U.S. corporation and those of the new foreign parent. Congress believed that "certain inversion transactions (involving 80 percent or greater identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes."[27] Although other "inversion transactions may have sufficient non-tax effect and purpose to be respected" – where there is less identity of stock ownership – "any applicable corporate-level 'toll charges' for establishing the inverted structure [should] not be offset by tax attributes such as net operating losses or foreign tax credits."[28]

III.

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[23] H.R. Rep. No. 755, 108th Cong., 2nd Sess. 568 (2004) (Conf. Rep.); H.R. Rep. No. 548 at 243; S. Rep. No. 192, 108th Cong., 1st. Sess. 141 (2003).

[24] S. Rep. No. 192, at 142; General Explanation of Tax Legislation, at 343.

[25] H.R. Rep. No. 755, at 569; H.R. Rep. No. 548, at 243-44; S. Rep. No. 192, at 141-42.

[26] Shareholders may have had little or no gain (for example, when stock prices declined), and the corporate level tax "may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes." H.R. Rep. No. 755, at 568-69; H.R. Rep. No. 548, at 243-44; S. Rep. No. 192, at 141-42.

[27] S. Rep. No. 192, at 142.

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IV.

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V. The and Their Acquisition of New X Equity Securities

Pursuant to the , the were entitled to receive $b . However, only a portion of the proceeds was actually received by the ; the remaining amount was acquired by New X as a result of the investing in New X Equity Securities. Specifically, shortly after becoming entitled to the $b , and pursuant to various agreements, the acquired all the Equity Securities from New X in exchange

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for an offset to the $d of cash they were entitled to receive [36] The issue is whether for tax purposes these two steps – that is, being entitled to receive $d of cash , and acquiring Equity Securities in New X in exchange for an offset to such right to receive cash – should be respected as separate and independent actions, or rather should be integrated under judicial doctrines such that the are treated as receiving the Equity Securities . Accordingly, the proper treatment of these steps is relevant both for purposes of determining whether the requirements in section 7874(a)(2)(B)(i) (regarding the acquisition of substantially all the properties) and 7874(a)(2)(B)(ii) (regarding stock ownership) are satisfied, as discussed in sections VI and VII, respectively, of the LAW AND ANALYSIS section of this memorandum.

A. In General

Section 7874, by its express terms, considers all aspects of the entire transaction at issue. For purposes of determining whether a foreign corporation is a surrogate foreign corporation, section 7874(a)(2)(B) considers all actions taken "pursuant to a plan (or a series of related transactions)." Thus, the statute itself first mandates that all aspects of "the plan" be taken into account. In general, case law interprets the term "plan" broadly to encompass all methods of putting into effect an intention, proposal or scheme.[37] The statute at hand, however, expands the already-broad "plan" standard by requiring that a series of transactions related to the plan must also be taken into account.[38] Thus, even if not technically part of the plan, broadly defined, transactions must be taken into account if they bear any relation to the plan.

In addition to this statutory directive to consider all actions taken pursuant to a plan – and transactions related to the plan – applicable judicial doctrines must be considered when characterizing transaction steps. Specifically, the substance of a transaction, and not its form, governs its treatment for tax purposes.[39] Under the step transaction doctrine, individual steps in a transaction are consolidated into a single integrated

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[36] The $d amount consisted of $ of cash actually transferred, with the remaining $c representing an offset against .

[37] See McCarthy v. Conley, 229 F. Supp. 517, 525 (D. Conn. 1964) ("Notwithstanding th[e] absence of a formal plan, the Court must consider whether or not any informal plan did exist as a matter of fact."); Shull v. Comm'r, 291 F.2d 680, 684 (4th Cir. 1961) ("A plan is a method of putting into effect an intention or proposal.") (quoting Burnside Veneer Co. v. Comm'r, 167 F.2d 214, 217 (6th Cir. 1948)).

[38] See also section 7874(c)(3), which treats all acquisitions of properties during a four-year period as being pursuant to a plan. Deeming all acquisitions occurring during such a period as being pursuant to a plan further evidences Congressional intent underlying section 7874 is to look to the substance of the entire transaction, rather than giving credence to individual steps of the overall transaction.

[39] See Comm'r v. Court Holding, 324 U.S. 331 (1945).

transaction in order to ensure that a transaction is taxed in accordance with its substance rather than its form.[40]

When applying the step transaction doctrine, courts must consider all steps in light of the entire transaction.[41]

Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine: (1) the "end result" test, under which the transaction will be collapsed if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result;[42] (2) the "mutual interdependence" test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series;[43] and (3) the "binding commitment" test, under which a series of transactions is collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step.[44]

If the step transaction doctrine applies to integrate a series of steps, courts will disregard those steps that do not reflect the substance of the overall transaction.[45] Thus, for example, courts will disregard a circuitous exchange of assets, or a circular flow of cash, for purposes of determining the tax consequences of a transaction.[46] It is also the long-standing ruling position of the Service to disregard circular flows of cash.[47]

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[40] Greene v. United States, 13 F.3d 577 (2d Cir. 1994); see also Minnesota Tea v. Helvering, 302 U.S. 609, 613 (1938) ("[a] given result at the end of a straight path is not made a different result because reached by following a devious path").

[41] Kirchman v. Comm'r, 862 F.2d 1486, 1491 (11th Cir. 1989) (citing Comm'r v. Court Holding Co., 324 U.S. 331 (1945)); Clark v. Comm'r, 828 F.2d 221, 227 (4th Cir. 1987) ("The step transaction doctrine . . . encourages the view of transactions in their entirety."); Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983) ("[t]axpayers cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status.") (internal quotations omitted).

[42] See King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

[43] See Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert denied*, 450 U.S. 913 (1981).

[44] See Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

[45] See Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 214 (D.C. Cir. 2001) (explaining that, under the step transaction doctrine, the Service and the courts may "ignore a step in a series of transactions"); Fidelity Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 233 (D. Mass. 2010) ("The step transaction doctrine is a judicial manifestation of the more general tax law ideal that effect should be given to the substance, rather than the form, of a transaction, by ignoring for tax purposes, steps of an integrated transaction." (quoting Falconwood Corp. v. United States, 422 F.3d 1339, 1349 (Fed. Cir. 2005)) (internal quotations omitted).

[46] See H.J. Heinz Co. & Subsidiaries v. United States, 76 Fed. Cl. 570, 587–92 (2007) (holding that a purchase by a subsidiary of stock of its parent on the open market, followed by a transfer several months later of such stock to the parent in exchange for a note, was a transaction to which the step transaction

B. Application to

The agreements underlying these two transaction steps, by their express terms, are interrelated and therefore part of the same plan. Under the Agreement 3, Q and P were required to purchase all the Equity Securities and related notes, and they reserved the right and intended to syndicate all or a portion of their obligation. The Agreement 1 specifically mentions the that was made by the group led by Q and P. In fact, the Agreement 1 and its exhibits, which include the Agreement 3, and the Agreement 2, together are referred to as the . Thus, the acquisition of the Equity Securities by the cannot be viewed as a separate transaction from the .

As described above, pursuant to the Agreement, Q and P, as majority holders of the , had the power to , and thus were able to . The acquired their interests in New X via the Memorandum 1, also referred to as the which commenced on , , and expired , . The limited amount of time during which potential investors could review and evaluate participation in the offering, as a practical matter, limited the offering to investors already familiar with X's business and the – that is, the . In addition, the limited class of eligible investors under the Agreement 3 explicitly included the .[48] Thus, P and Q specifically arranged to, and in fact successfully did, syndicate equity interests in New

doctrine applied and, as a result, concluding that the subsidiary's purchase and ownership of the parent stock must be ignored for tax purposes); Georgia Cedar Corp. v. Comm'r, 55 T.C.M. (CCH) 853 (1988) (applying the step transaction doctrine to disregard the circular flow of a note and, as a result, determining the relevant tax consequences based on the remaining (non-disregarded) steps).

[47] See Rev. Rul. 83-142, 1983-2 C.B. 68 (disregarding circular cash flows between parent and subsidiary in connection with spin-off); Rev. Rul. 80-154, 1980-1 C.B. 68 (treating cash distribution followed by purchase of stock in distributing corporation as stock dividend); Rev. Rul. 78-397, 1978-2 C.B. 150 (disregarding circular cash flow in connection with multi-step acquisition); Rev. Rul. 74-564, 1974-2 C.B. 124 (disregarding circular cash flow in connection with merger transaction).

[48] Memorandum 1, page 9. Under the Agreement 3, eligible participants in the offering included are described as:

X only to the . The standing as Old X is the origin of their opportunity and right to participate in the New X equity offering. In fact, the quantum of equity interest for which each holder of the Equity Securities could subscribe was determined based on , thereby making the equity purchase a function of their . Moreover, 100 percent of the New X

Equity Securities was acquired by .

Thus, under the statute, both the entitlement to the cash, and the acquisition of the New X Equity Securities in exchange for an offset to such entitlement, are taken into account together for purposes of determining whether New X is a surrogate foreign corporation. Next, the treatment of these steps, taken together, is considered under judicial doctrines – namely, the step transaction doctrine. As described below, together these two steps are treated as a single integrated transaction for tax purposes under all three formulations of the step transaction doctrine.

1. End Result Test

Under the end result test, purportedly separate transaction steps will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction, each intended from the outset to be taken for the purpose of reaching the ultimate result. This test focuses on the subjective intent of the parties when they structure the transaction.[49] In this case, the ultimate result is that all of the holders of the Equity Securities in New X were formerly . The agreement governing the mechanics of the issuance of the Equity Securities evidences an intention from the outset on the part of the Taxpayer, , and P and Q for to acquire the Equity Securities. Specifically, the Agreement 3 required P and Q (each a to purchase the entire $d of Equity Securities that was to be issued, and to offer to assign its right to purchase such Equity Securities to the holders of the . Thus, it was the intent and agreement of the parties from the outset that all of the Equity Securities would be held by former , and the end result test is satisfied.

2. Mutual Interdependence Test

The mutual interdependence test focuses on whether the steps are so interdependent that the legal relationships created by one transaction would have been fruitless without a completion of the series.[50] This test concentrates on the relationship between the

[49] See Superior Trading, LLC v. Comm'r, 137 T.C. 70 (2011).

[50] See Penrod v. Comm'r, 88 T.C. 1415 (1987).

steps, rather than on the end result.[51] The inquiry here is whether, taking into account the overall , there would have been an offering of the Equity Securities in New X absent the and the commitment from P and Q to purchase the Equity Securities in New X. The Agreement 1, the Agreement 3, and the Agreement 2 were all integrated, and as such one would not have been separately and independently executed. Specifically, the could not have been paid had and P and Q not committed to purchase equity in the new entity. In addition, since New X was a newly formed entity without capital, but for the required investment of P and Q and , it could not have paid Old X for the Acquired Properties, a critical component of the . In addition, the cash paid by New X to Old X for the Acquired Properties was then used to . Accordingly, without the required investment of P and Q and , the could not pay the the total amounts that they were due under the . Thus, the mutual interdependence test is satisfied.

3. Binding Commitment Test

The third test, the binding commitment test, provides for the application of the step transaction doctrine only where there is a binding commitment to take each step in a multi-step transaction. The facts at issue here also satisfy application of the binding commitment test. P and Q, themselves , were under a binding commitment to purchase the Equity Securities in New X. Thus, while other were technically under no legal obligation to purchase such interests, and P and Q intended from the outset to, and in fact did, offer them the opportunity to purchase the equity, even without such syndication, the Equity Securities in New X were required to be purchased by of Old X. Furthermore, as discussed above, immediately prior to the , the . The excess value attributed by the market to effectively dictated, from an economic perspective, that nearly all would be converted to equity in New X.

C. Analysis of Taxpayer Argument

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[51] See Assoc. Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991).

The Taxpayer asserts that the entitlement of the to of cash , and the acquisition of the Equity Securities , should be treated as separate and independent actions for tax purposes. In support of this theory, the Taxpayer asserts that the had no legal or contractual right to receive the Equity Securities . As a result, according to the Taxpayer, the Equity Securities were acquired in exchange for cash, rather than . Specifically, the Taxpayer argues that

, chose not to subscribe for the Equity Securities in New X. The Taxpayer states that neither the provided with the right to receive Equity Securities . Thus, the Taxpayer asserts that the form of the transaction steps should dictate the treatment of the transaction for tax purposes such that the and the acquisition of the Equity Securities should be treated as separate and independent actions.[52]

The involved myriad complex steps pursuant to various documents and related agreements. For tax purposes, these steps are characterized based on their overall substance and in light of the entire transaction. Under the facts and circumstances, the overall substance of these integrated steps is that the received all $d of Equity Securities .

The facts as analyzed above demonstrate that the acquisition of the Equity Securities by the was pursuant to the overall .
The Taxpayer's assertion that the Agreement 1 and Agreement 3 – the agreements pursuant to which the obtained their Equity Securities – were not related to the does not withstand scrutiny under examination. As indicated, the acquisition of the Equity Securities was pursuant to the Agreement 3, an agreement related to the , and so should be taken into account together with the , both in accordance with the specific mandate in section 7874, as well as long-established case law.

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D. Conclusion

The step transaction doctrine applies as long as the criteria of one of the tests are satisfied.[53] Here, however, each formulation of the step transaction doctrine applies with respect to the , and the acquisition by the of the Equity Securities in New X in exchange for an offset to that . Because the the acquisition of the Equity Securities are integrated under the step transaction doctrine, these two steps are characterized to reflect the overall substance of the transaction. Under the case law and long-standing Service ruling policy, the circular flow of cash –

is disregarded. Once the circular cash is disregarded, the remaining steps accurately reflect the substance of the transaction – that is, the receive the

Equity Securities . Furthermore, as discussed above, the statute itself makes clear that the entire transaction, including all related steps, should be analyzed together.[54] Thus, the characterization of this single integrated transaction is that the received the Equity Securities

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VI. The "Substantially All" Requirement

A. In General

The substantially all requirement under section 7874(a)(2)(B)(i) is met if the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. Thus, this requirement will be satisfied if New X directly or indirectly acquired substantially all of the properties held directly or indirectly by Old X.

The legislative history to section 7874 provides that "[i]t 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."[55] There are no regulations or other authorities that address the question of what

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[53] See Barnes Group Inc. et al. v. Commissioner, T.C. Memo. 2013-109, at 48 (citing Superior Trading, LLC v. Commissioner, 137 T.C. 70, 90 (2011) and Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991)).

[54] See section 7874(a)(2)(B).

[55] S. Rep. No. 108-192, n. 283 (Nov. 7, 2003) at 142.

constitutes substantially all of the properties held by the domestic corporation for this purpose. Thus, this requirement must be analyzed based on the plain meaning of the statutory language, taking into account the policies underlying the provision and Congressional intent.[56] The analysis should be based on all the relevant facts and circumstances of the particular transaction.

Under a plain reading of the statute, the determination is made based on the properties held by the domestic corporation at the time of the acquisition, after taking into account all transactions that occur prior to, and in connection with, the acquisition.[57] The properties fraction – that is, the percentage of the total properties held by the domestic corporation at the time of the acquisition that are acquired by the foreign acquiring corporation – is an important factor in determining whether the requirement will be satisfied. In addition, the statute makes no mention of liabilities of the domestic corporation, nor does it refer to "net" properties.[58] Thus, a plain reading of the statute indicates that, for this purpose, the value of the properties held by the domestic corporation ordinarily should be determined on a gross basis – that is, not net of liabilities. In addition, as discussed, section 7874 was enacted to prevent expatriations where the putative foreign corporation continues to conduct business in substantially the same manner as before the inversion.[59] As such, because the statute was designed with the continuing operation of a business in mind, it is appropriate that such business be valued on a going concern, rather than on a liquidation value, basis.

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[56] See Gaines Motor Lines, Inc. v. Klaussner Furniture Indus., Inc., 734 F.3d 296, 303 (4th Cir. 2013) ("As in any case of statutory interpretation, we begin with an analysis of the statutory language. The meaning of a statutory provision is not to be determined in isolation; we look not only to the particular statutory language, but to the statute as a whole and to its object and policy.") (internal citations and quotations omitted); United States v. Middleton, 231 F.3d 1207, 1210 (9th Cir. 2000) ("In interpreting a statute, we look first to the plain language of the statute, construing the provisions of the entire law, including its object and policy, to ascertain the intent of Congress.") (internal citations and quotations omitted); Rouse v. Iowa, 110 F. Supp. 2d 1117, 1124-25 (N.D. Iowa 2000) (explaining that if, after considering the plain meaning of a provision (taking into account the context, object, and policy of the statute), the provision is ambiguous, then a court "must look to other aids to determine congressional intent, including legislative history and the purpose, the subject matter and the condition of affairs which led to its enactment.") (internal citations and quotations omitted).

[57] As discussed in section V.A. of the LAW AND ANALYSIS section of this memorandum, section 7874, by its express terms, considers all aspects of the entire transaction at issue, broadly defined.

[58] Compare section 956(a) (amount of United States property taken into account under section 956(a)(1) is determined by reference to "[the property's] adjusted basis . . ., reduced by any liability to which the property is subject"); section 1244(c)(3)(B) ("the adjusted basis to the corporation of [the] property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation"); Treas. Reg. §1.312-10(a) ("net basis of the assets transferred and of the assets retained," and defining "net basis" as "the basis of the assets less liabilities assumed or liabilities to which such assets are subject"); Treas. Reg. §1.514(c)-2(d)(5)(i)(A) (taking into account "[t]he amount of money and the fair market value of property contributed by the partner to the partnership (net of liabilities assumed, or taken subject to, by the partnership).").

[59] S. Rep. No. 192, at 142; General Explanation of Tax Legislation, at 343.

B. Percentage of Properties Acquired

The denominator of the properties fraction is the gross value of the properties held directly or indirectly by Old X at the time of the acquisition, after taking into account all transactions prior to, and in connection with, the acquisition. The numerator of the properties fraction is the gross value of the Old X properties included in the denominator of the properties fraction that are acquired by New X.

The Taxpayer asserts that the substantially all requirement is not satisfied based on the treatment of the B Properties and the Properties. Accordingly, the Acquired Properties, the B Properties, and the Properties will be separately considered.

1. Acquired Properties

The Acquired Properties were held by Old X immediately before the acquisition and were acquired by New X. As a result, the gross value of the Acquired Assets is included in both the numerator and the denominator of the properties fraction.

2. B Properties

The B Properties were sold in connection with the . In form, the $b of sales proceeds received from . As explained in section V of the LAW AND ANALYSIS section of this memorandum, however, only $e of the $b purchase price is treated for tax purposes as ; the remaining $d is treated for tax purposes as being acquired by New X, in effect as a replacement asset for a portion of the properties sold to B.[60] Thus, the $d portion of the purchase price is included in both the numerator and the denominator of the properties fraction. In addition, the $e of proceeds distributed to the is not “held” by Old X at the time of the acquisition, after taking into account all transactions that occur prior to, and in connection with, the acquisition. Accordingly, the $e of cash proceeds is not included in the numerator or the denominator of the properties fraction.

Taxpayer asserts that the value of the B Properties (or, in the alternative, the $b received in exchange for the B Properties) should be included in the denominator, but not the numerator, of the properties fraction. First, Taxpayer asserts that this result

[60] As noted above, the $d amount consisted of $ in cash proceeds and $c .

follows from a plain reading of the statute because the B Properties were sold to B in connection with the and, therefore, were not acquired by New X. Taxpayer further asserts that the sales proceeds received by Old X from B should be taken into account in the denominator, but not the numerator, of the properties fraction because non-operating replacement assets, such as cash proceeds, do not constitute historic operating assets. Taxpayer believes the legislative history supports this position because section 7874 was intended to target transactions in which "corporations and other entities continue to conduct business in the same manner as they did prior to the inversion,"[61] and which have "little or no non-tax effect or purpose."[62] Taxpayer argues that the substantially all requirement is not satisfied in cases where significant business assets and operations are sold to a third party prior to, or in connection with, the acquisition because such transactions cannot be described as having "little or no non-tax effect."

However, the statute does not indicate or suggest that properties that are sold prior to, or in connection with, the acquisition should be included in the denominator, but not the numerator, of the properties fraction. Indeed, the statute by its terms provides otherwise, taking into account all steps pursuant to a plan or a series of related transactions. The statute applies with respect to "properties held by the domestic corporation" and, as discussed in section V of the LAW AND ANALYSIS section of this memorandum, for U.S. tax purposes the $d of the cash proceeds from the sale of the B Properties is treated as "held" by Old X immediately prior to the acquisition. In effect, Taxpayer asserts that there is an unstated requirement in section 7874(a)(2)(B)(i) that it does not apply with respect to all properties held by the domestic corporation, but rather applies only with respect to properties used in a historic business. Such a requirement, which would be similar to the continuity of business enterprise requirement for reorganization purposes,[63] should not be read into section 7874. In fact, when the provision is read in its entirety, it is clear that no such additional requirement is present or intended. Section 7874(a)(2)(B)(i), as applied with respect to domestic partnerships, is satisfied if the foreign corporation acquires "substantially all of the properties <u>constituting a trade or business</u> of the partnership" (emphasis added). There is no such "trade or business" requirement in section 7874(a)(2)(B)(i) as it applies with respect to properties of a domestic corporation. Nevertheless, Taxpayer's argument, in effect, requires that the "trade or business" qualifier in the rule that applies to domestic partnerships also applies to domestic corporations. If Congress had intended the trade

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[61] It should be noted here that throughout the Taxpayer's , New X is described as a continuation of Old X.

[62] S. Rep. 108-192, 142 (2003); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (2005) at 343.

[63] See Treas. Reg. §1.368-1(d). The continuity of business enterprise rule requires that the issuing corporation either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets in a business. Treas. Reg. §1.368-1(d)(1). Neither this rule, nor the reorganization rules in general, has any relevance to the application of section 7874.

or business requirement to apply to domestic corporations, the "trade or business" language would have modified "properties" in the context of both domestic corporations and domestic partnerships.[64]

Taxpayer's formulation is also contrary to the legislative history and general policies underlying section 7874. If Taxpayer's position were accepted, after any disposition of a significant portion of its historic operating assets – for example, through sale, disposition, or transfer in satisfaction of liabilities – a domestic corporation arguably could convert to a foreign corporation without being subject to section 7874. Congress could not have intended this result. Accordingly, the $b of cash proceeds received from B should not be given the special treatment suggested by the Taxpayer and instead must be taken into account in the properties fraction in the same manner as any other property.[65]

Taxpayer also asserts that even if the cash proceeds were to be considered as replacement properties, none of the cash was acquired by New X but rather . The Taxpayer notes that the phrase "substantially all" is not defined in section 7874, and asserts that the plain meaning of the term does not suggest that any portion of the domestic entity's assets should be excluded from the denominator of the properties fraction. Thus, according to the Taxpayer, none of the cash proceeds should be included in the numerator of the properties fraction because they were not acquired by New X. But, according to Taxpayer, the cash proceeds should still be treated as property held by Old X and therefore included in the denominator of the properties fraction.

As discussed above, $d of the $b sale proceeds, as replacement for the properties sold to A, is treated for tax purposes as being held by Old X immediately before the acquisition and as being acquired by New X. As a result, $d of the sale proceeds is included in both the numerator and the denominator of the properties fraction. The remaining $e of cash proceeds is treated for tax purposes as

[64] See Sebelius v. Cloer, 133 S. Ct. 1886, 1894 (2013) ("We have long held that where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotations omitted); Hamdan v. Rumsfeld, 548 U.S. 557, 578 (2006) ("A familiar principle of statutory construction . . . is that a negative inference may be drawn from the exclusion of language from one statutory provision that is included in other provisions of the same statute."); Sophy v. Comm'r, 138 T.C. 204, 211 (2012) ("When Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acted intentionally and purposely in so doing.") (internal quotations omitted).

[65] Even if the properties fraction were to be applied only to "historic operating assets," as Taxpayer asserts, it should be applied consistently. That is, only historic operating assets should be considered in the numerator and the denominator of the properties fraction. The properties fraction simply would not provide a meaningful indication of "substantially all" if it only took into account operating assets in the numerator, but took into account operating assets and all other properties in the denominator, as Taxpayer suggests.

being distributed from Old X
. The proper treatment of properties distributed to shareholders prior to, or in connection with, the acquisition turns on the meaning of the word "held." Section 7874(a)(2)(B)(i) only applies with respect to properties "held" by the domestic corporation. Thus, the question is whether properties that are distributed by the domestic corporation, either prior to or in connection with the acquisition, should continue to be treated as being "held" by the domestic corporation for purposes of the substantially all requirement. They should not. All aspects of the transaction, including distributions of property in connection with the ,. should be taken into account for purposes of this requirement. As discussed in Section V.A. of the LAW AND ANALYSIS section of this memorandum, section 7874 and judicial doctrines mandate that all aspects of the entire transaction, broadly defined, be taken into account. Under this standard, distributions
must be taken into account. Thus, because $e of the cash proceeds is treated as distributed pursuant to the
, the proceeds are not considered "held" by Old X and are not included in the denominator of the properties fraction.

Treating distributed properties as "held" by the domestic corporation and therefore included in the denominator of the properties fraction, as Taxpayer asserts, is also inconsistent with the purpose and policies underlying the substantially all requirement. Section 7874 is intended to prevent inversion transactions in which "corporations and other entities [ ] continue to conduct business in the same manner as they did prior to the inversion . . . ."[66] The requirement is intended to consider the extent to which the properties held by the domestic corporation immediately prior to the acquisition are held by the foreign acquiring corporation, as compared to properties that are retained and held by the domestic corporation. That is, it measures the extent to which the foreign corporation represents a continuation of the domestic corporation, as opposed to representing only a portion of the properties held by the domestic corporation with the domestic corporation continuing to hold other properties. To the extent the domestic corporation continues to hold properties, the foreign corporation represents less of a mere continuation of the domestic corporation.

In addition, including distributed properties in the denominator of the properties fraction would have the effect of inappropriately exempting numerous transactions from the application of section 7874. That is, this interpretation would arguably permit domestic corporations that distribute a sufficient amount of their properties – for example, as a dividend or a spin-off under section 355 – to immediately thereafter convert into a foreign corporation without being subject to section 7874. Congress did not intend this result.

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[66] S. Rep. 108-192, 142 (2003); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (2005) at 343.

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3. Properties

For the same reasons discussed above with respect to the $e of distributed proceeds from the sale of the B Properties, neither the Properties, nor proceeds from their sale , are included in the denominator of the properties fraction. These properties remained in Old X only for the purpose of being disposed of,

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Although the Properties differ from the B assets in that they had not been sold as part of the , the intent of Old X was to hold the assets for the sole purpose of

. Thus, they should be treated the same way as the portion of the A Properties that were used – that is, excluded from both the numerator and denominator of the properties fraction.[68]

C. <u>Gross Value of Properties</u>

Taxpayer asserts that the gross value of the properties should not be determined based on the independent third-party valuation provided by Taxpayer's Accounting Firm in

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68 We note that given their relatively small value – either $ or $, depending on the valuation study, or $ according to Taxpayer – the effect of including the Properties in the denominator of the properties fraction would be immaterial.

connection with the , but rather should be based on an implied valuation derived from trading of the in the period prior to the . Based on that methodology, the Taxpayer imputes the value of the Acquired Properties to be approximately $, rather than the approximately $ value determined by Taxpayer's Accounting Firm.

Relying on the price from trading of the during periods of time prior to the is not indicative of the gross values of the assets at the time of the acquisition, valued on a going-concern basis. The Taxpayer's Accounting Firm valuation report, prepared in contemplation of the and used to prepare the opening balance sheet of New X, is more reliable evidence of the value of the properties for purposes of the properties fraction. Taxpayer relied on this report in preparing its and its financial statements, both of which were released to the public. Accordingly, the gross values of the properties relevant for purposes of determining the properties fraction, based on the Taxpayer's Accounting Firm report, are as follows:

B Properties/Proceeds ($b) Proceeds transferred to New X Proceeds	 $d $e
Acquired Properties	$
Properties	$
Total	$

D. Conclusion

The Acquired Properties and $d of the proceeds from the sale of the B Properties are included in both the numerator and the denominator of the properties fraction. The properties that were sold in connection with the , or the cash proceeds from such sales used to , are not held by Old X at the time of the acquisition and therefore are not included in the numerator or the denominator of the properties fraction. Thus, the properties fraction is 100 percent, and New X acquired substantially all the properties held by Old X within the meaning of section 7874(a)(2)(B)(i).

When the is viewed in its entirety, as required under section 7874, a properties fraction of 100 percent is consistent with the overall substance and economic reality of the transaction. Only one of two things occurred with respect to all the properties held by Old X prior to the acquisition. They were either acquired by New X (Acquired Properties and $d of proceeds from the sale of the B Properties), or

they were sold,
of proceeds from the sale of the B Properties and all the proceeds from the sale of the
Properties). Other than the cash received from new investors, New X's properties consist only of properties held by Old X. Thus, New X is a complete successor to Old X, as reorganized, which is consistent with a properties fraction of 100 percent.[69]

VII. The "Ownership" Requirement

The ownership requirement under section 7874(a)(2)(B)(ii) is met if, after the acquisition, at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.[70] In addition, for this purpose "disqualified stock" is excluded from the denominator of the Ownership Fraction.[71] Thus, in analyzing the ownership requirement it is necessary to determine: (i) the amount of New X stock held by former shareholders of Old X, after the acquisition, by reason of holding stock in Old X, and (ii) the extent to which the New X Equity Securities constitute disqualified stock and, therefore, are excluded from the denominator of the Ownership Fraction.

A. Stock of New X Held by Reason of Holding Stock in Old X

1. In General

Treasury Reg. §1.7874-2T(f)(i) provides that for purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation includes stock of a foreign corporation received in exchange for, or with respect to, stock of a domestic corporation. The broad phrase "with respect to" contemplates a wide range of potential relationships. Accordingly, stock in the foreign corporation must be held as a result of some connection between the stock and being a former shareholder of the domestic corporation. Under the regulations, the phrase "by reason of" is construed broadly, and includes not only taxable and nontaxable exchanges and distributions,[72] but also any other transactions where stock in the foreign corporation is acquired because the shareholder held stock in the domestic

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[69] Even if, as Taxpayer asserts, the B Properties (or $e of the cash proceeds from the sale of the B Properties) are treated as held by Old X and therefore included in the denominator of the properties fraction, the properties fraction would still be over 90 percent ($ /), and therefore would still constitute substantially all for purposes of section 7874.

[70] Such stock ownership is also relevant for purposes of determining whether section 7874(b) applies.

[71] See section VII.B. of the LAW AND ANALYSIS section of this memorandum.

[72] Treas. Reg. §1.7874-2T(n)(2), Example 9.

corporation.[73] Accordingly, where stock of the foreign corporation is held as a result of being a shareholder of the domestic corporation (including as a result of being a creditor of an insolvent domestic corporation), the "by reason of" requirement is satisfied.

2. Application to Stock of New X

After the acquisition by New X of substantially all the properties of Old X, the Equity Securities were held by , the C, and former . In order to determine whether the Ownership Fraction is satisfied, the way in which these shareholders acquired their Equity Securities must be considered.

contributed $ in cash to New X in exchange for Equity Securities.[74] Thus, the Equity Securities received by were not held by reason of holding stock in Old X; instead, they were received by reason of contributing cash to New X. Similarly, P and Q and the contributed $ and $ in cash, respectively, to New X in exchange for Equity Securities. Therefore, the portion of the Equity Securities received by the in exchange for cash was not held by reason of holding stock in Old X.

All of the remaining Equity Securities were acquired by , in form, in exchange for . As discussed in section V of the LAW AND ANALYSIS section of this memorandum, however, the substance of these two integrated steps is that the received their New X Equity Securities . Thus, the Equity Securities in New X were acquired in exchange for, or with respect to – and, therefore, by reason of – . Accordingly, the New X Equity Securities received by the are included in the numerator and the denominator of the Ownership Fraction.

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[73] See TD 9453, 2009-28 I.R.B. 114, Section E.1, which explains that the "temporary regulations also clarify that the 'by reason of' condition may be satisfied other than through exchanges or distributions."

[74] As noted above in Section VI of the FACTS section of this memorandum, the Equity Securities were then transferred from to the C. The C received its equity interests in New X, at least in part, in exchange for its agreement to of Old X (See dated .) As a result, the Equity Securities received by the C also may be viewed as being held "by reason of" its . Thus, regardless of whether they are viewed as having been issued to in exchange for cash, or issued to the C in exchange , the Equity Securities will not reduce the Ownership Fraction.

B. Exclusion of New X Stock from the Denominator of the Ownership Fraction

On September 17, 2009, the Service and Treasury Department issued Notice 2009-78 (2009-40 IRB 452). Notice 2009-78 announced that regulations would be issued under section 7874 that would identify certain stock of the foreign corporation that is disregarded for purposes of the ownership test. These regulations would address transactions intended to avoid the application of section 7874 that involved transfers of cash (or certain other assets) to the foreign corporation in a transaction related to the acquisition described in section 7874(a)(2)(B)(i).

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Notice 2009-78 states that regulations will provide that stock of the foreign acquiring corporation issued in exchange for "nonqualified property" in a transaction related to the acquisition is not taken into account for purposes of the ownership fraction, without regard to whether such stock is publicly traded on the date of issuance or otherwise. The notice further provides that the term nonqualified property includes cash or cash equivalents. Finally, the notice states that the regulations will apply to acquisitions completed on or after September 17, 2009.

On January 17, 2014, the Service and Treasury Department issued temporary regulations implementing the rules described in Notice 2009-78.[75] The preamble to the temporary regulations explains that the Service and Treasury Department are concerned with transactions intended to avoid section 7874 that involve a transfer of cash or other assets to the foreign corporation in exchange for additional equity, such that the ownership requirement would not be satisfied.[76] Accordingly, the temporary regulations modify the statutory public offering exclusion rule in section 7874(c)(2)(B) to take into account a non-public offering of stock for certain property (including cash) that "presents the same opportunity to inappropriately reduce the ownership fraction."[77] The preamble notes, as an example, that "a private placement of the stock of a foreign acquiring corporation in exchange for cash raises the same policy concern that the ownership fraction will be inappropriately reduced by increasing the net assets of the foreign corporation."[78]

Treasury Reg. §1.7874-4T(b) provides that, subject to a de minimis exception not relevant here, disqualified stock is treated as stock described in section 7874(c)(2)(B)

[75] TD 9654. 79 FR 3095 (January 17, 2014).

[76] Id.

[77] Id.

[78] Id.

and therefore is not included in the denominator of the ownership fraction.[79] Disqualified stock includes stock transferred to a person (other than the domestic entity) in exchange for nonqualified property. Treasury Reg. §1.7874-4T(i)(7) defines nonqualified property to include cash or cash equivalents. Consistent with the effective date announced in Notice 2009-78, these rules apply to acquisitions completed on or after September 17, 2009.[80]

The Equity Securities were transferred by New X to in exchange for cash, which is nonqualified property. Similarly, New X transferred a portion of the Equity Securities to P and Q and to the (in their capacity as financiers rather than as) in exchange for cash. As a result, under Treas. Reg. §1.7874-4T(b) the Equity Securities, and the portion of the Equity Securities transferred to P and Q and to the in exchange for cash (in their capacity as financiers rather than as), are not included in the denominator of the Ownership Fraction.[81]

C. Analysis of Taxpayer Argument

Taxpayer asserts that section 7874(b) does not apply because Q and P received a portion of their Equity Securities in New X not by reason of , but rather in their capacity as promoters or investors in exchange for an undertaking to provide financing to New X.[82]

Under the Agreement 3, P and Q were required to provide $d in equity financing to New X in exchange for all of its Equity Securities. In fact, as set forth in the Summary of provided by the Taxpayer, P

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[79] Treasury Reg. §1.7874-4T(c)(2) provides that stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities. This limitation only applies to acquisitions completed on or after January 16, 2014, however, and therefore does not apply to the transaction at issue. Treas. Reg. §1.7874-4T(k)(2)(iii). Even if this limitation did apply, it would not affect the analysis because the transfer of the New X Equity Securities in exchange for cash increased the fair market value of the assets of New X.

[80] Treas. Reg. §1.7874-4T(k)(1).

[81] See footnote 90, noting that even if certain Equity Securities are viewed as not having been received in exchange for cash, they should be viewed as having been received by reason of Old X.

[82] The Taxpayer also asserted that the acquired the New X Equity Securities in exchange for cash, and not by reason of , and therefore did not satisfy the ownership requirement. This argument is addressed in Section V of the LAW AND ANALYSIS section of this memorandum.

and Q and the provided approximately $ in equity financing, and syndicated the remaining portion of their obligation (as they were permitted to do under the Agreement 3), with approximately $ ultimately being provided by and approximately $ being provided by other . According to the Taxpayer, in exchange for a cash investment of approximately $, P and Q and the received an aggregate of approximately $. The Taxpayer claims that the of approximately $ must have been attributable to Q and P's actions as promoters and lead investors in providing a financing commitment to New X. The Taxpayer argues that the Equity Securities received in exchange for this financing commitment should qualify neither as being received in exchange for cash, such that they are not disqualified under Treasury Reg. §1.7874-4T, nor as received "by reason of" . Thus, the Taxpayer asserts that this stock should be included in the denominator, but not the numerator, of the Ownership Fraction.

The Taxpayer's argument that P and Q received additional and disproportionate equity value in New X based on their entrepreneurial involvement is disproven by a straightforward analysis of the on which the Taxpayer relies. Importantly, as is illustrated by the Taxpayer's summary, all the owners of Equity Securities, including the , and not just P and Q, were awarded on exactly the same terms, with every investor receiving credit of $f for each $1 of cash deemed invested.[83] The contributed approximately $ in exchange for Equity Securities of approximately $. Similarly, the contributed approximately $ and were awarded an aggregate of approximately $. Thus, the and the received $f in

New X Equity Securities for every dollar of cash contributed ($ /$ and $, respectively), which is equal to the $f value that P and Q received for each dollar they invested in New X ($ /$

[83] In all, $ of cash was contributed to New X in exchange for equity. The initial value of New X immediately after the , as indicated by the , was $. Thus, the value of the non-cash property acquired from Old X must have been equal to $. This approximately $ of property was not contributed by any shareholder of New X, but rather simply reflects the value of the Old X assets acquired by New X pursuant to the . For purposes of determining the parties' in New X, the value attributable to the $ in non-cash property was allocated among the classes of New X equity, with the Equity Securities purchased by being credited with approximately $ and the Equity Securities purchased by the being credited with approximately $.

). Therefore, it cannot be the case that P and Q were awarded additional equity in exchange for services rendered in having secured financing, or on any other basis. Instead, they received Equity Securities on the same terms as all of the other holders. This is also made clear in the Memorandum 1, which states:

[84]

There are no agreements, documents or other evidence to suggest that P and Q or the received New X Equity Securities in exchange for a financing commitment or as Taxpayer now asserts. Indeed, all of the agreements and documentation reflect the simple fact that the Equity Securities were issued on the exact same terms and conditions to all parties, and that P and Q and the had no rights separate and apart from those .[85]

P and Q did not enter into any agreement, or any other arrangement, to provide a financial commitment or deal-making services in exchange for Equity Securities, or any other property. Instead, P and Q simply . Like all the other , and consistent with , P and Q received New X stock . All rights and value received by P and Q derived from , and only from . But for , P and Q had no rights whatsoever to receive New X stock or any other property pursuant to the .

D. Calculation of the Ownership Fraction

The shareholders of New X – the former – acquired their New X stock in only one of two ways: (1) by reason of ; and (2) in exchange for cash. To the extent the New X stock is held by reason of

[84] See Memorandum 1, page 7.

[85] As discussed above, the Taxpayer has argued that the . Assuming, *arguendo*, that such a characterization is correct, it implies that new investors with no prior connection to the entity could buy $f worth of Equity Securities for each dollar invested. As noted above, that $f per Equity Security is the same price as was paid by P and Q. Thus, even under the Taxpayer's characterization of the transaction, there cannot have been any excess value awarded to P and Q for their "dealmaking" services.

, it is included in both the numerator and the denominator of the Ownership Fraction. To the extent the stock was acquired in exchange for cash, it is not included in either the numerator or the denominator of the Ownership Fraction.[86] Thus, the Ownership Fraction is 100 percent.

An Ownership Fraction of 100 percent is consistent with the overall substance and the economic reality of the . Stated simply, after the acquisition New X holds only two categories of properties: (1) properties formerly held by Old X; and (2) cash. Because the New X stock issued to and other investors in exchange for newly invested cash is not included in either the numerator or the denominator of the Ownership Fraction, all the remaining stock of New X reflects the Old X properties acquired by New X and, therefore, is included in both the numerator and the denominator of the Ownership Fraction, which would yield an Ownership Fraction of 100 percent.

This result is also consistent with the policies underlying the Ownership Condition of section 7874(a)(2)(B)(ii) and the exclusion rule under Treas. Reg. §1.7874-4T(b). The Ownership Condition is intended to measure the extent to which the foreign acquiring corporation (New X) represents a mere continuation of the domestic corporation (Old X).[87] The exclusion rule provides that, for this purpose, cash and other nonqualified property are not taken into account.[88] Thus, for example, if a newly formed foreign corporation holding no other property acquires all the assets held by a domestic corporation in exchange for stock, the Ownership Fraction is 100 percent. A 100 percent Ownership Fraction reflects the fact that the foreign acquiring corporation holds no properties other than those held by the domestic corporation and therefore represents nothing more than a continuation of the domestic corporation. The result would be the same, as a result of the application of Treas. Reg. §1.7874-4T(b), if the foreign corporation also issued stock to an investor, in connection with the acquisition of the assets held by the domestic corporation, in exchange for cash – that is, the Ownership Fraction would still be 100 percent. This is the case because the foreign corporation holds only property held by the domestic corporation and cash, which is nonqualified property. The Ownership Fraction would potentially be reduced below 100 percent only to the extent the foreign acquiring corporation held property prior to the acquisition, or acquired qualified property (as defined in Treas. Reg. §1.7874-4T(i)(7)) in exchange for stock in a transaction related to the acquisition of the properties of the domestic corporation. The Ownership Fraction is reduced in such cases because the foreign acquiring corporation does not merely reflect a continuation of the domestic

[86] The stock is not included in the numerator because it was not held by reason of holding stock in Old X; it is not included in the denominator as a result of the application of Treas. Reg. §1.7874-4T(b).

[87] S. Rep. No. 192, 108th Cong., 1st. Sess. 142.

[88] This result is consistent with the rule in section 7874(c)(2)(B), which excludes from the numerator and denominator of the Ownership Fraction stock sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i).

corporation, but rather represents a combination of the domestic corporation and the other properties held by the foreign acquiring corporation.

Here, New X is a newly formed foreign corporation and therefore did not hold any properties prior to the acquisition of the properties of Old X. In addition, the New X Equity Securities that were issued in a transaction related to the acquisition of the properties held by Old X were issued solely in exchange for cash, which is nonqualified property. held all the prior to the and – along with and the C – held all the New X stock after the . Accordingly, the only significant change effected by the transaction is that the Old X business, along with newly invested cash, is now conducted in the form of a foreign – rather than a domestic – corporation. This is the prototypical transaction that section 7874 was enacted to prevent.[89] Therefore, a 100 percent Ownership Fraction is not only the proper technical application of the rules, but is wholly consistent with the policies underlying the ownership requirement.

The treatment of all the shareholders of New X and the calculation of the Ownership Fraction are summarized as follows:

New X Shareholders	**By Reason Of:**	**% of Equity**	**Treatment**	**§7874 Owner-ship Test Fraction**
(100% of)	Cash	%	Excluded	N/A
C (100% of)	Cash (from B)	%	Excluded	N/A
Q & P (as financiers)	Cash	%	Excluded	N/A
(as financiers)	Cash	%	Excluded	N/A

[89] See, S. Rep. No. 108-192 (2003) at 142 ("In particular, these [inversion] transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion . . . . The Committee believes that certain inversion transactions (involving 80 percent or greater identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes.")

(including Q and P and		%	Included in Numerator and Denominator	100%[90]

VIII. The "Substantial Business Activities" Requirement

A. In General

The substantial business activities requirement under section 7874(a)(2)(B)(iii) is met if after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group. Whether the statutory requirement is satisfied, therefore, depends on the comparative level of business activities in the foreign country measured against the level of total business activities of the group worldwide. In light of this statutorily-required comparison, the requirement may be satisfied (that is, one may conclude that the necessary "substantial" level of business activities is not present) by a seemingly large level of business activities in the foreign country which nevertheless is not substantial in the overall context of the worldwide business activities of the group. Thus, this requirement will be satisfied if, after the acquisition, the New X EAG does not have substantial business activities in Country 1, when compared to the total business activities of the New X EAG.

The legislative history addresses the substantial business activities test in section 7874 as follows:

> The Congress believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the

[90] As discussed above, the Equity Securities ultimately received by the C could alternatively be viewed as having been acquired by reason of the C's . Similarly, because Q and P had the power to control the , the Equity Securities they acquired in their capacity as financiers could also be viewed as having been acquired by reason of their standing as . Furthermore, the , even in their capacity as financiers, were only allowed to participate in the offering as a result of their standing as in Old X, such that even the Equity Interests they acquired in their capacity as could be viewed as having been acquired by reason of their . In all cases, the Ownership Fraction would remain 100 percent.

inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations.[91]

In June of 2006, the Service and Treasury Department issued a first set of temporary regulations (2006 regulations) that provided guidance on the substantial business activities requirement.[92] The 2006 regulations set forth both a general all-facts-and-circumstances rule[93] and a "bright-line" safe harbor for purposes of determining whether an expanded affiliated group has substantial business activities in a given foreign country. Under the safe harbor, an expanded affiliated group was considered to have substantial business activities in a country if each of the following 3 requirements was satisfied:

- Employees. After the acquisition, the group employees based in the foreign country accounted for at least 10 percent (by headcount and compensation) of total group employees;

- Assets. After the acquisition, the total value of the group assets located in the foreign country was at least 10 percent of the total value of all group assets; and

- Sales. During a one-year period preceding the acquisition,[94] the group sales made in the foreign country accounted for at least 10 percent of total group sales.

In general, the 2006 regulations applied to acquisitions completed on or after June 6, 2006, and prior to June 9, 2009.

In June of 2009, the Service and Treasury Department issued new temporary regulations ("2009 regulations") that replaced the 2006 regulations.[95] The 2009 regulations retained a facts-and-circumstances provision largely similar to that contained in the 2006 regulations, but did not retain the safe harbor. The preamble to the 2009 regulations explained that the safe harbor was not retained because it "may apply to certain transactions that are inconsistent with the purposes of section 7874,

[91] S. Rep. No. 192, at 142; General Explanation of Tax Legislation, at 343.

[92] TD 9265, 2006-2 C.B. 252.

[93] The general facts-and-circumstances rule under 2006 regulations is largely similar to the sole facts-and-circumstances provision contained in the 2009 regulations, discussed below.

[94] The one-year period, referred to as the "testing period," is the 12-month period ending on the last day of the expanded affiliated group's monthly or quarterly management accounting period in which the acquisition is completed.

[95] Treas. Reg. §1.7874-2T(g) (2009) (as amended by TD 9453, 2009-2 C.B. 114).

which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership)."[96]

Under the 2009 regulations, the substantial business activities determination is based on all facts and circumstances. The determination is not based solely on the absolute amount of business activities in the foreign country. Rather, the determination is based on a comparison of the amount of business activities in the foreign country to the total business activities of the expanded affiliated group.[97]

The 2009 regulations provide that the relevant items to be considered in the facts-and-circumstances determination include the following:

> (i) The historical conduct of continuous business activities in the foreign country by the expanded affiliated group.
>
> (ii) The conduct of continuous business activities in the foreign country by the expanded affiliated group in the ordinary course of one or more active trades or businesses, involving—
>
> > (A) Property located in the foreign country that is owned by members of the expanded affiliated group;
> >
> > (B) The performance of services in the foreign country by employees of the expanded affiliated group; and
> >
> > (C) Sales of goods to customers.
>
> (iii) The performance in the foreign country of substantial managerial activities by officers and employees of the expanded affiliated group who are based in the foreign country.
>
> (iv) A substantial degree of ownership of the expanded affiliated group by investors resident in the foreign country.
>
> (v) Business activities in the foreign country that are material to the achievement of the overall business objectives of the expanded affiliated group.[98]

[96] TD 9453, 2009-2 C.B. 114.

[97] Treas. Reg. §1.7874-2T(g)(2) (2009).

[98] Id.

The 2009 regulations require the determination of substantiality to take into account the total business activities of the group, including the above relevant items. The presence or absence of any item, or set of items, is not determinative. Moreover, the weight given to any item, or set of items, depends on the facts and circumstances.[99]

In general, the 2009 regulations apply to acquisitions completed on or after June 9, 2009, and before June 7, 2012.[100] Accordingly, the 2009 regulations apply for purposes of determining whether the New X EAG meets the substantial business activities requirement in section 7874(a)(2)(B)(iii).

B. Applicable Foreign Country

New X, treated as a foreign corporation created or organized in Country 1 for purposes of section 7874, is an entity described in section 7874(a)(2)(B)(i). Accordingly, in determining whether New X is a surrogate foreign corporation within the meaning of section 7874(a)(2)(B) it must be determined whether the expanded affiliated group that includes New X has substantial business activities in Country 1.[101]

C. Analysis of Taxpayer's Position on "Substantial Business Activities"

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[99] Id.

[100] Treas. Reg. §1.7874-3T(f) (2012 regulations). In June of 2012, the Service and Treasury Department issued new temporary regulations that replaced the facts-and-circumstances determination contained in the 2009 regulations with a bright-line rule. Under this rule, in general the expanded affiliated group will have substantial business activities only if at least 25 percent of the expanded affiliated group's total group employees (by number and employee compensation), group assets, and group income, is located or derived in the foreign country. TD 9592, 2012-28 I.R.B. 41 (2012). The preamble to the 2012 regulations states that the all-facts-and-circumstances determination was replaced by a bright-line rule because the latter "will provide more certainty in applying section 7874 to particular transactions than the 2009 temporary regulations and will improve the administrability of this provision."

101

Taxpayer asserts that the substantial business activities requirement should be interpreted in a manner such that business activities are substantial if they are "more than minimal". This assertion largely rests on the legislative history quoted above that inversion transactions resulting in a "minimal presence" in a foreign country "are a means of avoiding U.S. tax and should be curtailed."[102]

Taxpayer's interpretation takes the legislative history reference to "minimal presence" out of context, which points to an example of an abuse targeted by the statute, but does not define the scope of the statutory response to the abuse. The statute plainly speaks of "substantial," not "minimal" business activities, and requires a facts and circumstances comparison between the applicable foreign country and the worldwide group. The regulations set forth the item-based determination of the threshold, and do not turn on any minimal floor. Indeed, the elimination of the prior safe harbor belies any minimalistic measure.

Prior to the enactment of section 7874, a U.S.-parented multinational group of corporations could become foreign parented for U.S. federal tax purposes, even if it had previously conducted no activities whatsoever in the jurisdiction of the foreign parent. These so-called "naked" inversion transactions drew the ire of members of Congress prior to the enactment of section 7874,[103] and accordingly it is natural that Congress would state in the legislative history, as an example, that such transactions were abusive. However, this statement does not imply that any transaction passes muster because the expanded affiliated group's business activities in the country were more-than-minimal. Congress easily could have drafted an anti-abuse statute with such a limited scope if it had wanted to do so; for example, it could have simply chosen the phrase "does not have more than minimal business activities" instead of "does not have substantial business activities" in drafting section 7874(a)(2)(B)(iii). Congress made the standard "substantial business activities," and the term should be interpreted in a manner consistent with the plain meaning of the word "substantial" in this context: "considerable in amount, value, or worth."[104]

Taxpayer's interpretation of "substantial" to equal "more-than-minimal" would frustrate the over-arching policy set forth in section 7874's legislative history, removing the incentives for transactions that allow formerly U.S.-parented entities from conducting

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[102] S. Rep. No. 192, at 142; General Explanation of Tax Legislation, at 343.

[103] For example, in describing a 2002 bill that was similar to the enacted version of section 7874, Senators Grassley and Baucus described inversion transactions in which "these foreign parent corporations are nothing more than a sheet of paper in a filing cabinet." Grassley and Baucus called such an inversion "a purely paper transaction, with no substantive change in the current business operations of the U.S. corporation or its foreign subsidiaries." Ranking Member Chuck Grassley (R-IA) and Chairman Max Baucus (D-MT), Reversing the Expatriation of Profits Offshore (REPO) Act Press Briefing Memo, Tax Analysts Doc. No. 2002-8923.

[104] Webster's Third New International Dictionary of the English Language Unabridged 2280 (1986).

business with a foreign parent in the same manner as they did prior to the inversion transaction, especially where the transaction lacks "non-tax effect and purpose."[105]

Finally, and consistent with the legislative intent, the regulations interpreting substantial business activities make clear that the term "substantial" cannot be interpreted to mean "more-than-minimal." The preamble to the 2006 temporary regulations, which contained a similar facts-and-circumstances test to the regulations at issue, makes clear that the regulations were not intended to permit inversion transactions where the expanded affiliated group's activities were simply more-than-minimal. The preamble states that "the IRS and the Treasury Department believe that Congress was concerned about transactions where the new foreign parent entity is incorporated in a country in which the expanded affiliated group does not have a bona fide business presence that is meaningful in the context of the group's overall business"[106] (emphasis added). The subsequent elimination of the 10 percent safe harbor provides further support that the regulations should not be interpreted based on a "more-than-minimal" standard. The safe harbor was removed because it was considered to be insufficiently stringent–not because it was too difficult to satisfy.[107]

Accordingly, the substantial business activities requirement is not interpreted based on the "more-than-minimal" standard, as Taxpayer asserts. Instead, the requirement in section 7874(a)(2)(B)(iii) will not be satisfied only if the New X EAG's Country 1 business activities are substantial when compared to its total business activities.

D. Application of Items Enumerated in 2009 Regulations to the New X EAG

The New X EAG's Country 1 business activities must be evaluated based on all the facts and circumstances, including the five items set forth in the 2009 regulations. The key to the substantiality determination under the statute and the regulations is a comparison of the amount of business activities in Country 1 to the total activities of the New X EAG worldwide. Thus, while the business activities in Country 1 may seem sizeable, they will fail to constitute substantial business activities within the meaning of the statute and regulations if relatively insubstantial when considered in the overall context of the EAG's total worldwide business activities. As discussed below, the facts and circumstances, including the items enumerated in the 2009 regulations, do not

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[105] S. Rep. No. 192, at 142.

[106] TD 9265.

[107] TD 9453 (74 FR 27,922). "The IRS and the Treasury Department have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership). The temporary regulations, therefore, do not retain the safe harbor provided by the 2006 temporary regulations."

support the position that the New X EAG conducted substantial business activities in Country 1 for purposes of section 7874.

1. Historical Conduct of Continuous Business Activities

X was formed in Year 2 , a historically U.S.-based , combined its operations into a single subsidiary. The divisions from which X was formed conducted business activities in the United States by since its founding in Year 1, and X has conducted business activities in the United States since its formation. Thus, prior to the X and the divisions from which it was formed had conducted business activities continuously in the United States for approximately years.

X has no similar historical conduct of continuous business activities in Country 1. As recently as the years Year 3 through Year 4, X had only a nominal presence in Country 1.[108] X's Country 1 business activities were expanded beyond this nominal presence in Year 6 as a result of the acquisition of the E business.

Taxpayer asserts that it historically conducted substantial activities in Country 1 because it had conducted operations in Country 1 since it first became an independent company in Year 5 . Taxpayer further notes in support of this contention the acquisition of E in Year 6.

The regulations are devoid of any suggestion that the "historical conduct of continuous activities in the foreign country" may be supplied by a recent acquisition; the contrary suggestion follows from the plain meanings of "historical" and "continuous." Similarly, the regulations do not support the Taxpayer's notion that the historical conduct of continuous business activities begin only when they are operated in an "independent company" -- as opposed, for example, to being operated in a subsidiary or division of its predecessor company .[109]

The regulations require that the substantiality determination, including the relevant items, in this instance the historical conduct of continuous business activities, must take into account the total business activities of the EAG. Thus, the relevant period of time

[108] In each of these years, less than percent of X's net property at year-end was located in Country 1, and Country 1 represented slightly over percent of its net sales. By comparison, over percent of X's net property and net sales were in Country 6 in each of such years.

[109] We distinguish between historical activities of the predecessor corporations the businesses (or stock) of which were acquired through mergers or stock for stock exchanges, and the historical activities of business entities which were merely purchased. The predecessor corporations which were merged or acquired for stock are really just continuing in a different corporate form; accordingly, their activities are relevant for this factor. However, the historical activities of the corporations, or the corporations' businesses, which were merely purchased for cash are not relevant to the analysis of this factor.

for assessing this item is the -year history of X. The X business activities have been conducted continuously in the United States – and not Country 1 – over X's entire -year history. X conducted almost no meaningful business activities in Country 1 until the acquisition of D in Year 6.[110] Thus, X has not historically conducted continuous business activities in Country 1.

2. The Conduct of Continuous Business Activities

a. Property located in Country 1

Currently, New X operates its business in countries through approximately sites, of which are located in Country 1 (percent). Country 1 assets generally were associated with New X's E business, which constitutes a segment of one of its core businesses, the business. Country 1 assets generally were not associated with New X's other core business segments.

Based on New X's financial statements, as of Date 3, Year 8, New X's Country 1 assets constituted percent of X's total property, plant and equipment. This amount is based on book value, which approximated the fair market value of the assets. Taxpayer's tax opinion states that the New X EAG's Country 1 assets account for percent of the group's total book value as of the same date.[111]

The Taxpayer asserts that the Country 1 assets constitute much higher percentages of the New X EAG's total assets. Taxpayer asserts that the cash (in excess of $) held in Country 6 should be excluded from the calculation because cash is passive in nature and therefore not relevant in measuring "business activities." Taxpayer also asserts that including passive assets in the calculation would be manipulable. Excluding the cash from the value of the gross assets, as Taxpayer asserts, would result in percent of the assets being located in Country 1. Taxpayer also asserts that the comparison should be based on the fair market value of the assets, net of liabilities. Taking into account the value of assets (including cash) less liabilities would result in percent of the assets being located in Country 1[112]; excluding the cash

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[110] The historic Country 1 presence of D should not be taken into account in this analysis. Treasury Reg. §1.367-3(c)(3)(ii) contains a special rule that the active trade or business test of Treas. Reg. §1.367-3(c)(*3*)(i)(A) is satisfied when the transferee foreign corporation acquired at the time of the exchange, or any time prior to the exchange, a trade or business that had been active throughout the entire 36 month period preceding the exchange. The section 7874 regulations do not contain such a rule, and, as already noted, they do not suggest that historical business activities can be acquired.

[111] Taxpayer's Tax Counsel opinion, page 10.

[112] Appraiser concluded that the net equity value of X's Country 1 entities represented percent of X's business enterprise value as of , .

and taking into account assets reduced by liabilities would result in percent of the assets being located in Country 1.

However, nothing in the regulation suggests that cash should be excluded from the calculation. While it is true that passive investment-type assets may not be indicative of active business activities in many cases,[113] New X's cash was not held in this capacity. Indeed, the Taxpayer's own draft tax opinion acknowledges that "the approximately in cash provided by and the … was contributed to [New X] "[114] In other words, without this capital, X might not have Accordingly, the cash is an important part of the New X EAG's business activities and therefore must be taken into account for this purpose.

In addition, measuring the assets net of liabilities is inconsistent with a plain reading of the regulation and the policy underlying the provision. The 2009 regulations provide that "property located in the foreign country" should be considered. This language does not provide that liabilities are relevant or should otherwise be taken into account.[115] In addition, taking into account liabilities could produce artificial and inappropriate results because an expanded affiliated group, depending on its financial situation, may be able to choose which member of the group will borrow the necessary funds, and then to move the cash around through contributions and distributions.

This relative amount of Country 1 assets is not indicative of substantial business activities in Country 1 when compared to the total business activities of the New X EAG.

b. The performance of services in Country 1

As of Date 1 , Country 1 employees represented approximately percent of the New X EAG's employees and percent of its payroll. This relative amount of Country 1 services is not indicative of substantial business activities in Country 1 when compared to the total business activities of the New X EAG.

c. The sales of goods in Country 1

[113] Indeed, the preamble to the 2006 regulations provides that "the statutory phrase 'business activities' ordinarily does not include passive investment activities and related income and assets" and that investment activities should not "be given any significant weight." TD 9265, 2006-2 C.B. 252.

[114] Taxpayer's Tax Counsel opinion, page 10.

[115] For example, the regulations could have provided that "net properties" or "properties reduced by the amount of liabilities" are considered. See, supra, footnote 58.

For the nine months ended Date 1, , percent of the X EAG's total sales were made in Country 1, including sales to affiliates, and percent of X's net sales were from goods in Country 1 for the period from , through , . This relative amount of Country 1 sales is not indicative of substantial business activities in Country 1 when compared to the total business activities of the New X EAG.

3. Substantial Managerial Activities

At the time of the , the New X EAG's headquarters and top management responsible for the EAG's overall business objectives and leadership were located in Country 6, not Country 1.[116] In addition, the regional headquarters of the New X EAG were in Country 2, Country 3, and Country 4, not Country 1. In fact, the divisional offices for X's business unit, of which the majority of New X's Country 1 assets were a part, were located in Country 4, not Country 1. As of Date 1, , only percent of New X EAG's executives, responsible for overseeing local Country 1 operations, were located in Country 1. This relative amount of Country 1 local managerial activities is not indicative of substantial business activities in Country 1 when compared to the total business activities of the New X EAG.

4. Degree of Ownership by Investors Resident in Country 1

At the time of the , none of the holders of the New X Equity Securities was resident in Country 1. Accordingly, investor ownership does not support a finding of substantial business activities in Country 1.

5. Business Activities Material to Overall Business Objectives

New X has asserted that its E business located in Country 1 is important to the achievement of its objectives. In addition, its facilities in Country 1 produce other parts.

The materiality of the New X EAG's Country 1 business activities under the regulations must be measured in the context of the total business activities and the overall business objectives of the EAG as of the time of the . The Country 1 business operations are not highlighted in the business model as described in public filings:

[116] In its Country 1 tax filings, New X reported that it was managed and controlled in Country 6 rather than Country 1.

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.[117]

This discussion makes no mention of Country 1. In addition, Taxpayer does not suggest that its Country 1 operations contribute to its model. Such public filings also stated that X intends to focus its business on markets as

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[118] This is a category of countries that clearly does not include Country 1 (or, for that matter, , the largest market for its).

Further, although the New X EAG had a small number of executives and members of management in Country 1, its headquarters and overall management were located in Country 6 at the time of the . Accordingly, the New X EAG's Country 1 business activities were not responsible for the group's overall leadership at the time of the .

Finally, the New X EAG's Country 1 activities are relatively small when compared to its worldwide activities, which include main businesses:

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As noted above, Country 1 operations were largely focused on E systems, which is only one segment of one of these businesses. In its , X stated that its , and were located in major centers in enumerated countries. As Country 1 was not included in that list, the centers located in Country 1 were not considered to be "major" by New X. The was later amended to state that New X has major centers in enumerated countries, including Country 1, only after the lack of any reference to Country 1 was noted by the Service.

The Country 1 operations do contribute to one stated strategic objective of New X, that is, to develop focused on creating that are . It

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118 Id., at 97. In fact, as of Year 9 the New X EAG employed approximately employees in Country 3, which is approximately times greater than its number of Country 1 employees as of Year 8.

is not clear how important the E business is to the objective, however, as X Country 5's made little mention of in its discussion of this objective.[119] Further, any such contribution is made within one out of divisions of the business, and to one of several overall business objectives. Thus, while this contribution may be important by itself, as noted under the statute and regulations, the substantiality determination must take into account the total business activities of the expanded affiliated group. Under all the facts and circumstances Country 1 business activities are not material to the achievement of the overall business objectives of the EAG.

E. Conclusion

Following is a summary of the foregoing analysis of the items to be considered under the regulations in assessing whether the Taxpayer had substantial business activities in Country 1 when compared to the total business activities of the EAG:

Item	**New X EAG - Percentage in Country 1**
Historical Business Activities	No
Property Located in Country 1	
Operating Sites	%
Property	%
Services	
Headcount	%
Compensation	%
Sales	%
Managerial Activities	
Executive Officers	%

[119] For example,
section of the Business discussion did not mention , and the section entitled
only mentioned it once, in a sentence that did not differentiate E and
). See
, at .

Regional Management Local Management	% %
Country 1-Resident Owners	None
Business Activities Material to Overall Business Objectives	No

Under the regulations, the substantial business activities determination is based on all facts and circumstances. The determination is not solely based on the absolute amount of business activities in the foreign country. Rather, the determination is based on a comparison of the amount of business activities in the foreign country to the total business activities of the expanded affiliated group. The regulations require the determination of substantiality to take into account the total business activities of the group, including the above relevant items. The presence or absence of any item, or set of items, is not determinative. Moreover, the weight given to any item, or set of items, depends on the facts and circumstances.

After examining all of the facts and circumstances, including the items enumerated in the 2009 regulations, after the acquisition the New X EAG does not have substantial business activities in Country 1 when compared to its total business activities. Although its Country 1 business activities may be viewed as being more than minimal, this is not the relevant standard. The Country 1 activities of the New X EAG must be substantial when compared to its total business activities. From both a quantitative and qualitative perspective, the New X EAG's Country 1 business activities are not substantial when compared to those of the entire New X EAG. They were insubstantial in size and scope relative to New X's overall business activities and objectives – historically, at the time of the , and under its business model. Therefore, after the acquisition the New X EAG does not have substantial business activities in Country 1, when compared to the total business activities of the New X EAG, and the requirement in section 7874(a)(2)(B)(iii) is satisfied.

IX.

[120]

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Treasury Reg. §1.7874-2T(m)(3) provides that if a foreign corporation is treated as a domestic corporation pursuant to section 7874(b), section 367 does not apply to any transfer of property by a United States person to such foreign corporation as part of the acquisition described in section 7874(a)(2)(B)(i).[122]

As noted above in section III of the LAW AND ANALYSIS section of this memorandum, for purposes of section 7874 New X is a foreign corporation . In addition, as discussed in sections VI, VII and VIII of the LAW AND ANALYSIS section of this memorandum, each of the three requirements in section 7874(a)(2)(B) is satisfied and, as a result, New X is treated as a surrogate foreign corporation. As discussed in section VII of the LAW AND ANALYSIS section of this memorandum, the Ownership Fraction is 100 percent and, as a result, New X is a surrogate foreign corporation to which section 7874(b) applies.

. Finally, under Treas. Reg. §1.7874-2T(m)(3) the transfer of property from Old X to New X is not subject to section 367.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[120]

[121]

[122] The regulation further provides, however, that section 367 does apply to the conversion of the foreign corporation to a domestic corporation.

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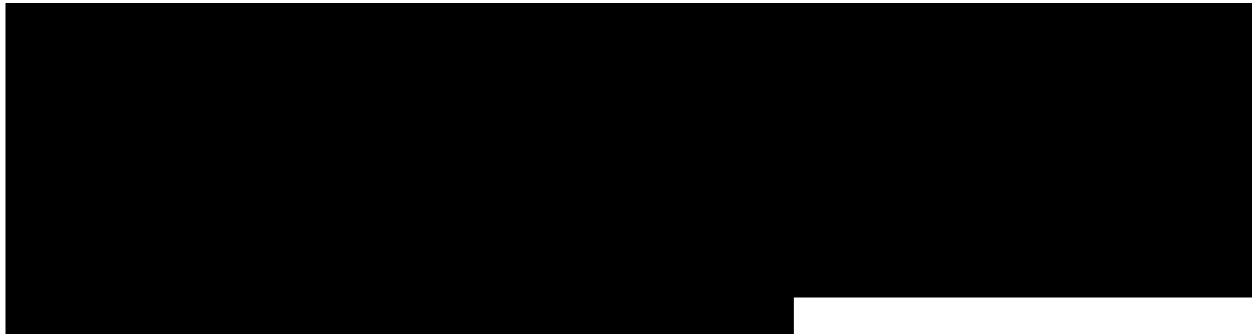

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