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Kevin M. Cunningham

Ian A. Simmons

Kevin M. Cunningham is a managing director with the international tax group in the Washington National Tax practice of KPMG LLP, and Ian A. Simmons is a senior manager with the corporate tax group in the Washington National Tax practice of KPMG.

In this article, Cunningham and Simmons explain how the rules concerning disqualified stock and non-ordinary-course distributions can inappropriately create an inversion under section 7874, and they argue that the IRS should amend the safe harbor de minimis exception.

To many, the U.S. anti-inversion rules under section 7874 are a problem solely for large foreign multinational corporations acquiring domestic corporations or partnerships when stock constitutes a significant part of the consideration. While those transactions may fall most clearly within the purview of section 7874, the scope of the rules is broader than most people realize.

Because section 7874 applies to acquisitions of domestic entities only if "after the acquisition at least 60 percent of the stock (by vote or value)" of the foreign acquiring corporation is held "by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation" or "by former partners of a domestic partnership by reason of holding a capital or profits interest in the domestic partnership,"[1] it would seem as if the anti-inversion rules should apply only if most — or at least a good portion — of the purchase consideration consists of share consideration that provides the domestic entity owners with a continuing proprietary interest in the foreign acquiring corporation.

But as others in the tax community have recently pointed out, the anti-inversion rules can cause a foreign acquiring corporation to be viewed as a surrogate foreign corporation (or as a domestic corporation under section 7874(b)) even when the purchase consideration consists entirely of cash or other non-stock consideration.[2]

The reason, discussed further below, is the interaction of the so-called disqualified stock rule and the non-ordinary-course distributions (NOCD) rule. The disqualified stock rule in section 7874(c)(2) and reg. section 1.7874-4 causes stock of the foreign acquiring corporation to be disregarded from the ownership calculation if it was transferred in a transaction related to the acquisition of the domestic target entity and in exchange for money or other nonqualified property.[3]

For tax and regulatory reasons, private equity investors will often use a new foreign corporation to acquire a domestic target entity. Thus, the shares that are issued by the new foreign corporation to its investors will often be issued for cash or other non-stock consideration and in a transaction related to the acquisition of the

[1] *See* section 7874(a)(2)(B)(ii).

[2] *See* Nils Cousin, Ege Berber, and Jose Rego, "Beware the Accidental Inversion: Traps for the Unwary in Common Deal Scenarios," *Tax Notes Federal*, Oct. 2, 2023, p. 41.

[3] *See generally* reg. section 1.7874-4.

domestic target entity and therefore fall within this disqualified stock rule. In that case, those newly issued foreign acquiring corporation shares are not taken into account in the calculation, in which case the ownership percentage in an all-cash, non-stock transaction will be "zero divided by zero."

More specifically, the numerator (which measures the value (or vote) of foreign acquiring corporation stock received by reason of holding an equity interest in the domestic entity, adjusted under the section 7874 regulations) is zero because it is a cash purchase and there is no rollover, and the denominator (which measures the total value (or vote) of the foreign acquiring corporation's shares, again adjusted under the section 7874 regulations) is zero because all of the foreign acquiring corporation's shares are disqualified stock and therefore not taken into account when computing the ownership percentage described in section 7874(a)(2)(B)(ii).

If that were the end of the analysis, the tax result might be manageable. While it is not totally clear how the mathematical result of a fraction divided by zero should be viewed in this context, the IRS has ruled in non-precedential guidance that a fraction of zero over zero will not satisfy the requirement described in section 7874(a)(2)(B)(ii) (that is, that at least 60 percent of the vote or value of the stock of the foreign acquiring corporation is held by former owners of the domestic entity by reason of holding equity in the domestic entity).[4] Despite a taxpayer's inability to rely on non-precedential guidance, the ruling that zero over zero does not equal or exceed 60 percent is generally sufficient for tax advisers to feel confident that their client is not subject to section 7874.

However, it is here that a second rule, the so-called NOCD rule, can apply and cause a commensurate increase to both the numerator and the denominator of the "zero-over-zero" fraction, resulting in an ownership percentage of 100 percent and possibly causing the newly formed parent foreign corporation to be viewed as a domestic corporation for U.S. tax purposes.[5]

The NOCD rule was designed as an anti-skinny-down rule to prevent a domestic entity from making large distributions shortly before an acquisition to shrink itself, reducing the ownership percentage under section 7874(a)(2)(B)(ii) and otherwise avoiding the anti-inversion rules. The effect of the NOCD rule is to increase the numerator and the denominator of the fraction (determined by value, not vote) so as to counteract the effect of the skinny-down distribution. Because of the broad definition of distribution, the NOCD rule might apply in many private equity transactions even if the domestic target did not make any distributions in the years preceding its acquisition. As discussed below, the NOCD rule is arguably broad enough to include situations in which a domestic target guarantees acquisition debt — a common scenario in private equity acquisitions.

Moreover, although there is a safe harbor — a de minimis exception — that can prevent both the NOCD rule and disqualified stock rule from applying, the safe harbor requires that there be limited cross-ownership between the acquiring and target groups, and the exception tests whether such cross-ownership exists under broad constructive stock ownership rules. Because private equity groups often have complex ownership structures, it often won't be possible for them to disprove common ownership (and thus show that they qualify for the safe harbor), especially when the complexities of constructive stock ownership are taken into account. Thus, it seems that many all-cash private equity acquisitions of a domestic target entity could trigger the application of the anti-inversion rules and cause the foreign acquiring corporation to be treated as a domestic entity under section 7874(b), even though no stock consideration is used.

The answer to all this is for the IRS to amend the de minimis exception to provide that a foreign acquiring corporation will be viewed as satisfying

[4] *See* LTR 201432002 (May 1, 2014).

[5] *See generally* reg. section 1.7874-10. A foreign acquiring corporation that has completed an acquisition of a domestic entity described in section 7874(a)(2)(B)(i) with an ownership percentage of 100 percent may still avoid treatment as a surrogate foreign corporation (or domestic corporation under section 7874(b)) if it satisfies the "lack of substantial business activities requirement" described in reg. section 1.7874-3.

the safe harbor (or, at least, is permitted to avail itself of the safe harbor), assuming it has exercised some measure of reasonable diligence in concluding that there is minimal or no cross-ownership between the foreign acquiring corporation and the domestic target entity (and reasonable diligence would, for this purpose, be defined). Planners can then be confident that some amount of incidental cross-ownership in the transaction will not cause them to fall into the anti-inversion rules. Most importantly, upon examination they will not be required to prove to an auditor that there is no cross-ownership among the two entities, which is often nearly impossible given the breadth of the constructive ownership rules and the complex ownership structures in private equity.

I. Section 7874

Section 7874 was added to the code in 2004 in response to several high-profile expatriations of domestic corporations.[6] The statute was designed to impose corporate-level consequences on those types of expatriations, or "inversion transactions."[7] In general, section 7874 applies when: (1) a foreign acquiring corporation directly or indirectly acquires substantially all the properties held directly or indirectly by a domestic corporation (or substantially all the properties constituting a trade or business of a domestic partnership) (such acquisition, a "domestic entity acquisition," and the requirement, the "acquisition requirement"); (2) after the domestic entity acquisition, at least 60 percent of the stock (by vote or value) of the entity is held by former shareholders (or partners) of the domestic entity *by reason of* holding stock (or partnership interest) in the domestic entity (the "ownership requirement"); and (3) after the domestic entity acquisition, the "expanded affiliated group" that includes the entity does not have substantial business activities in the foreign country where, or under the laws of which, the foreign acquiring corporation is organized, when compared with the total business activities of such expanded affiliated group (the "lack of substantial business activities requirement").[8]

If all three requirements are satisfied and the ownership requirement percentage is less than 80 percent, the foreign acquiring corporation is treated as a "surrogate foreign corporation"; the domestic entity and all related U.S. persons are treated as "expatriated entities"; and some controlled foreign corporations owned by expatriated entities are treated as "expatriated foreign subsidiaries."[9]

There are many punitive provisions that apply to surrogate foreign corporations, expatriated entities, and expatriated foreign subsidiaries. For example, dividends from surrogate foreign corporations cannot be treated as "qualified dividend income."[10] Another example is that an expatriated entity (1) cannot use attributes to reduce gain or income from related-party sales or licenses (including the section 250 deduction), (2) is subject to a clawback of some section 965(c) deductions,[11] and (3) must include all payments to the surrogate foreign corporation or a related foreign corporation as "base erosion payments" for purposes of the base erosion and antiabuse tax without reduction for cost of goods sold.[12] And special section 956 rules apply to some property held by expatriated foreign subsidiaries.[13]

If all three requirements are satisfied and the ownership requirement percentage is 80 percent or higher, the foreign acquiring corporation is treated as a domestic corporation for all U.S.

[6] Section 801(a) of the American Jobs Creation Act.

[7] While beyond the scope of this article, shareholder-level consequences of inversion transactions are addressed by section 367 (generally denying the deferral of taxation on outbound transfers of U.S. assets or stock in a domestic corporation), and "decision-maker" consequences are addressed by section 4985 (imposing a 20 percent excise tax on the stock-based compensation of some insiders of the domestic entity being expatriated).

[8] The lack of substantial business activities requirement is likely to be satisfied in the context of private equity because of regulatory changes that were issued in temporary and proposed form in 2012 and finalized in 2015. *See* reg. section 1.7874-3T(f) (2012) (superseded); reg. section 1.7874-2. *See also* Kevin M. Cunningham, "The New Section 7874 Substantial Business Activity Exception Regulations: Closing the Door," *Tax Notes Int'l*, Sept. 3, 2012, p. 961.

[9] Section 7874(a)(2)(B); reg. section 1.7874-12(a)(9).

[10] Section 1(h)(11)(C)(iii)(II).

[11] Section 965(l). A section 965(c) deduction is the deduction allowed to a United States shareholder regarding the required inclusion of the subpart F income — as specially determined under section 965 — of a deferred foreign income corporation for its last tax year that begins before January 1, 2018.

[12] Section 59A(c)(2)(A)(iv).

[13] Reg. section 1.956-2(a)(4).

federal income tax purposes. It is worth noting that this second consequence is usually a far worse tax consequence than classification as a surrogate foreign corporation or expatriated entity. In this case, there are usually subsidiaries of the foreign corporation that become subject to the CFC rules, and unexpected withholding tax liabilities arise.

Also, the designation as a domestic corporation is only for U.S. federal income tax purposes, so the foreign acquiring corporation would still be treated as a tax resident (and thus subject to tax) in the country in which it is organized or managed and controlled. Thus, some transactions might proceed when the ownership requirement percentage is 60 percent or greater, but less than 80 percent, but an ownership requirement percentage of 80 percent or greater will almost always require that the transaction be restructured.

The section 7874 regulations provide several antiabuse rules, many of which adjust the ownership requirement percentage by either (1) decreasing the value of the denominator to counteract transactions that inflate the value of the foreign acquiring corporation (that is, stuffing transactions) or (2) increasing the value of the numerator to counteract transactions that diminish the value of the domestic entity (that is, skinny-down transactions). While these adjustment rules are based on principles of antiabuse, intended to undo the effects of transactions undertaken to improperly deflate the ownership requirement percentage, they are mechanical rules that generally do not consider the intent behind the transactions potentially falling within their scope.

II. The Disqualified Stock Rule

The principal rule guarding against "stuffing transactions" is the disqualified stock rule of reg. section 1.7874-4. The regulation was promulgated under the authority of section 7874(c)(2)(B), which provides that:

> (2) Certain stock disregarded. There shall not be taken into account in determining ownership under subsection (a)(2)(B)(ii) —
>
> . . .
>
> (B) stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i).

The reason for the disqualified stock rule is clear: It would be easy to decrease the ownership requirement percentage (and thus avoid an inversion) if a foreign acquiring corporation could acquire a domestic entity and then issue new shares in a primary offering around the same time as the acquisition. For example, assuming the primary offering was at least 21 percent of the value (and vote) of the foreign acquiring corporation (taking into account the effect of the offering and domestic entity acquisition), the ownership requirement percentage would be 79 percent or lower, depending on the size of the offering, and thus avoid the harsher tax consequences of the anti-inversion rules. An offering constituting more than 40 percent of the value (and vote) of the foreign acquiring corporation could drive the ownership requirement percentage below 60 percent, taking the transaction entirely out of the anti-inversion regime (caused by the ownership requirement not being satisfied).

Section 7874(c)(2)(B) provides that such stock shall be disregarded only if it is "sold in a public offering" related to the domestic entity acquisition, and if the rule were so limited, private equity transactions would not be affected. However, the IRS decided that it was necessary to extend the disqualified stock rule to private issuances as well, otherwise the aforementioned planning could be used to avoid an inversion when the stock of the foreign acquiror was not "sold in a public offering." In 2009 Treasury and the IRS issued Notice 2009-78, 2009-40 IRB 452, effective for acquisitions occurring on or after September 17, 2009, stating that:

> The IRS and Treasury have become aware of transactions intended to avoid the application of section 7874 that involve a transfer 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), thereby minimizing the former shareholders' ownership in the foreign corporation for

> purposes of the Ownership Condition. *In one such transaction, for example, the shareholders of a domestic corporation (DC) transfer all their DC stock to a newly-formed foreign corporation (New FCo) in exchange for 79 percent of the stock of New FCo and, in a related transaction, an investor transfers cash to New FCo in exchange for the remaining 21 percent of the New FCo stock.* The parties to the transaction take the position that the New FCo stock issued to the investor is not "sold in a public offering" and thus not subject to section 7874(c)(2)(B). The parties also assert that the transfer of cash from the investor to New FCo was not part of a plan a principal purpose of which is to avoid the purposes of section 7874 such that section 7874(c)(4) does not apply to disregard the investor's transfer of cash to New FCo in exchange for New FCo stock. [Emphasis added.]

To expand the definition of disqualified stock beyond it being issued in a public offering, the notice relied on the authority in section 7874(c)(4) and (c)(6). Section 7874(c)(4) provides that "the transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a principal purpose of which is to avoid the purposes of this section." And section 7874(c)(6) provides that "the Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations . . . (B) to treat stock as not stock."

That notice was followed by a litany of guidance addressing inversions, a significant portion of which related to the disqualified stock rule: temporary regulations in 2014,[14] which were issued as proposed regulations on the same day; two other notices, Notice 2014-52, 2014-41 IRB 712, and Notice 2015-79, 2015-49 IRB 775; new temporary regulations issued in 2016;[15] final regulations issued in 2017;[16] and amended final regulations issued in 2018.[17]

As of the date of writing, disqualified stock is generally defined, in principal part, as stock of the foreign acquiring corporation that "is transferred to a person other than the domestic entity in exchange for nonqualified property" (whether in a public offering or not),[18] in a transaction related to the domestic entity acquisition that increases the value of the assets (or decreases the liabilities) of the foreign acquiring corporation. Nonqualified property is defined as (1) cash and cash equivalents, (2) marketable securities (as defined in section 453(f)(2)), (3) some obligations owed by related parties, and (4) any other property acquired with a principal purpose of avoiding the purposes of section 7874.[19]

The disqualified stock rule above is unclear about what happens if there is no rollover in the acquisition, but all the stock issued by the foreign acquiring corporation is disqualified stock. For example, assume investors form a foreign corporation and fund it with cash that it uses to purchase all the stock of a domestic corporation. As it so happens, that arrangement describes a structure that is similar to many private equity acquisitions.

In that case, there is no rollover and thus no "by reason of" stock, so the numerator of the fraction is, absent further adjustment, zero. But all the stock is disqualified, so the denominator is zero as well, meaning the ownership requirement arguably is not satisfied. As discussed in a 2014 private letter ruling involving a reorganization followed by a public offering, the IRS seemingly blessed that interpretation, stating that "the Ownership Fraction will be zero over zero. Accordingly, the requirement described in section 7874(a)(2)(B)(ii) will not be satisfied, and FA will not be a surrogate foreign corporation within the meaning of section 7874(a)(2)(B)."[20] Of course,

[14] T.D. 9654, 79 F.R. 3094 (Jan. 17, 2014).

[15] T.D. 9761 (Apr. 8, 2016).

[16] T.D. 9812 (Jan. 18, 2017).

[17] T.D. 9834 (July 11, 2018).

[18] Reg. section 1.7874-4(c)(1)(i).

[19] Reg. section 1.7874-4(h)(2).

[20] LTR 201432002 (May 1, 2014).

private letter rulings cannot be used or cited by taxpayers as precedent.[21] Thus, taxpayers that rely on that interpretation of a zero-over-zero fraction do so to some extent at their own peril, especially because the consequences of being wrong are so significant.

III. The NOCD Rule

The disqualified stock rule would be pernicious enough if its effect was to require the tax planner to wrestle with the implications of a "zero-over-zero" ownership requirement percentage. However, shortly after the 2014 temporary regulations were issued, the IRS issued Notice 2014-52, which indicated that a new rule to increase the ownership requirement percentage — now referred to as the NOCD rule — would be coming. The NOCD rule is designed to combat large distributions of property made by the domestic target during the period shortly before an acquisition by increasing the numerator and the denominator of the ownership requirement percentage to offset the effect of the distribution.

The operation of the NOCD rule is complex; in summary it operates by a purely mechanical test by which the distributions during some lookback years are aggregated and compared against the average distributions for the 36 months preceding the lookback year. If the amount of distributions in any of the lookback years exceeds 110 percent of the average distributions in its distribution history period, the excess is an NOCD and added back to (and therefore increases) the numerator and the denominator of the ownership requirement percentage.[22]

If that were the end of it, it would be relatively easy to perform due diligence regarding whether the domestic target had made any large distributions possibly subject to the NOCD rule. But — and most critically in the private equity context — the definition of a distribution also includes "a transfer of money or other property to the former domestic entity shareholders (or partners) that is made in connection with the domestic entity acquisition to the extent the money or other property is directly or indirectly provided by the domestic entity."[23] While the regulations provide scant guidance on the scope of "directly or indirectly provided," it seems as if it should apply when the domestic borrower provides credit support for a debt the proceeds of which funded the cash acquisition.

For example, in the private equity context, a newly formed wholly owned domestic subsidiary of the foreign acquiring corporation will often borrow and use those proceeds to purchase the domestic target from its shareholders. In those cases, the lender to this domestic subsidiary is generally relying on the credit, and presumably an explicit guarantee, of the domestic target to repay the loan. Thus, there is a significant risk that the cash consideration furnished to the target shareholders will be viewed as "directly or indirectly provided" by the target domestic entity and treated as a distribution that gives rise to an NOCD for purposes of section 7874.

Moreover, the acquisition indebtedness generally will exceed the distributions made by the domestic target in the lookback period. And in that case, the NOCD rule will cause a positive number to be added to both the numerator and the denominator, so that the fraction goes from "zero over zero," for which there was a strong argument that no inversion occurred, to 100 percent — an unquestioned inversion. And then there is a tax catastrophe — the foreign acquiring corporation is a surrogate foreign corporation that is treated as a domestic corporation for "all purposes of this title" (that is, title 26 — the entire Internal Revenue Code).

It is unlikely that the IRS was aware of this lethal combination of the NOCD rule and the disqualified stock rule when it first issued the NOCD rule in 2014. Indeed, it took advisers some time to become aware of how this complicated dynamic can cause an inversion in an otherwise "all-cash" transaction. Thus, advisers began to counsel private equity to use either a domestic acquiring corporation or a passthrough platform structure to avoid this risk, despite other tax inefficiencies of doing so. Advisers who are not aware of it might organize the acquiring corporation outside the United States and fall into

[21] Section 6110(k)(3).

[22] *See* reg. section 1.7874-10.

[23] Reg. section 1.7874-10(k)(1)(iii).

this trap for the unwary and otherwise expose their client to the painful consequences of the anti-inversion rules.

IV. History of the De Minimis Exception

After 2009, when the disqualified stock rule was issued, but before 2014, when the NOCD rule was released, commentators began to focus on the fact that transactions with little rollover could result in a zero-over-zero transaction, or even possibly an inversion transaction, because of the breadth of the disqualified stock rule. It is worth quoting a significant portion of the preamble to the 2014 proposed and temporary regulations here to understand the IRS's thinking in addressing these comments:

> Comments asserted that both the statutory public offering rule and the rule set forth in the notice that disregards stock issued in exchange for nonqualified property can lead to inappropriate results when the former owners of the domestic entity own only a minimal equity interest in the foreign acquiring corporation after the acquisition. These comments recommended that, in such a case, the regulations provide exceptions from the application of those rules.
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> . . .
>
> Comments recommended an exception for transactions that in substance resemble a purchase by the foreign acquiring corporation of a substantial portion of the stock of the domestic entity from the former owners of the domestic entity. The comments asserted that this may occur, for example, when a significant amount of the consideration received by the former owners of the domestic entity is cash (or other nonqualified property) that, related to the acquisition, was received by the foreign acquiring corporation in exchange for its stock (which stock would not be taken into account in determining the ownership fraction under the notice). *The comments stated that section 7874 should not apply to such transactions because the former owners of the domestic entity sold the majority of their interests in the domestic entity.* These comments recommended that the exclusion rule be limited to transactions in which the former owners of the domestic entity own at least a threshold percentage of the equity of the foreign acquiring corporation.
>
> The IRS and the Treasury Department agree that an exception from the exclusion rule is appropriate for certain transactions, but believe that any such exception should apply only when the former owners of the domestic entity own a de minimis equity interest in the foreign acquiring corporation after the acquisition. Accordingly, the temporary regulations provide that the exclusion rule will not apply to *certain transactions involving unrelated parties if the ownership fraction, determined without regard to the exclusion rule, is less than five percent (by vote and value)*. [Emphasis added.][24]

In response to those comments, the 2014 proposed, temporary regulation provided a "de minimis" exception to the disqualified stock rule if the ownership requirement percentage was less than 5 percent (by vote or value), not taking into account the disqualified stock rule. However, as noted, the preamble language states that the exclusion applies only to "certain transactions involving unrelated parties" if the ownership requirement percentage is less than 5 percent.

And reflecting that limitation, the exclusion, which the 2014 temporary regulations refer to as the "de minimis ownership rule," provided that:

> (d) *Exception to exclusion of disqualified stock*. (1) *De minimis ownership.* Except as provided in paragraph (d)(2) of this section, paragraph (b) of this section [the disqualified stock rule] does not apply if both:
>
> > (i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section [the

[24] T.D. 9654, 2014-1 C.B. 461, 466.

> disqualified stock rule], is less than five percent (by vote and value); and
>
> (ii) After the acquisition and all transactions related to the acquisition, if any, are completed, former shareholders (within the meaning of section 1.7874-2(b)(2)) or former partners (within the meaning of section 1.7874-2(b)(3)), as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) any member of the expanded affiliated group that includes the foreign acquiring corporation.[25]

Notably, the first clause (i) tests rollover; that is, whether the ownership requirement percentage is less than 5 percent, disregarding the disqualified stock rule. If an acquisition is a 100 percent cash purchase, or even a 95.1 percent cash purchase with a 4.9 percent stock rollover, that condition would usually be met. Also and importantly, the rollover percentage for purposes of clause (i) should be readily determinable. Clause (ii), however, tests continuity, that is, whether the acquisition involves unrelated buyers and sellers, and requires that all former shareholders or partners of the domestic target entity own less than 5 percent of each member of the expanded affiliated group that includes the foreign acquiring corporation.

In making this determination, section 318(a) attribution is taken into account, which will cause, among other things, (1) a person to be viewed as owning shares of their spouse, children, grandchildren, or parents, (2) some shareholders, partners, or beneficiaries to be viewed as owning shares held by a corporation, partnership, or trust that they hold shares or an interest in, (3) some corporations, partnerships, or trusts to be viewed as holding shares held by their shareholder, partner, or beneficiary, and (4) some options to be treated as exercised.[26]

Also, as quoted above, section 318(a) attribution is determined taking into account the modifications of section 304(c)(3)(B). This modification provides even more breadth to the section 318(a) attribution rules. The constructive ownership rules of section 318(a)(3)(C) and section 318(a)(2)(C), which attribute stock to and from a corporation, respectively, normally are applied based on 50 percent ownership thresholds. The modifications of section 304(c)(3)(B) require that those rules be applied based on 5 percent ownership (with some proportionality limitations) rather than 50 percent ownership threshold, which is a significant difference.[27]

For example, assume Mr. X is a shareholder in a domestic target entity that is acquired by a newly formed foreign acquiring corporation entirely for cash. The disqualified stock rule, if applicable, might cause the ownership requirement percentage to be adjusted to "zero over zero" (that is, no rollover in the numerator, but since all the shares of the foreign acquiring corporation were issued for cash, the denominator is zero as well). Clause (i) of the de minimis test, which measures "by reason of" ownership, is certainly satisfied because none of domestic target's shareholders have acquired an interest in foreign acquiring "by reason of" their ownership in domestic target; all the shares were transferred for cash. Thus, it might be possible to increase the denominator to the entire value (or vote) of the stock of the foreign acquiring corporation, and make the percentage clearly zero, if it can be shown that the clause (ii) overlapping ownership test is satisfied.

Under clause (ii) of the de minimis test as it existed in 2014, neither Mr. X nor any other shareholder of domestic target, in the aggregate and taken together, can own 5 percent of foreign acquiring corporation (or its affiliates) immediately after the acquisition either directly, indirectly, or constructively. Importantly, unlike

[25] Reg. section 1.7874-4T(d) (2014).

[26] *See* section 318(a).

[27] *See* section 304(c)(3)(B). The ownership is only proportionate in these cases.

clause (i), clause (ii) ownership is determined "without regard" to whether the domestic entity shareholders acquired their interest in the foreign acquiring corporation "by reason of" their ownership in the domestic acquiring corporation.

That analysis requires at least six steps.

First, all the shareholders that held stock in the domestic entity, including Mr. X, must be identified. For this purpose, only shareholders that *held* shares in the domestic entity are relevant (that is, shareholders that owned shares only indirectly or constructively do not matter).[28]

Second, it must be determined that Mr. X does not own a *direct* interest in the foreign acquiring corporation (or some closely related corporate affiliates of the foreign acquiring corporation). If foreign acquiring is acquired by a private equity investor, individuals will usually not be direct owners of foreign acquiring; the shares will be held by corporate blockers or investment partnerships. Thus, it will be relatively easy to disprove Mr. X's direct ownership.

Third, it must be determined that Mr. X does not own an *indirect* interest in the foreign acquiring corporation. That is, on the foreign acquiring side of the house, the unpermitted ownership includes section 318 ownership, which is broad enough to reach indirect ownership. This analysis is much harder than step two, especially in private equity. In private equity, the investment partnership and corporate shareholders will often have a complex web of indirect ownership involving other partnerships or corporations, sometimes with special classes of interests. Under the section 318 indirect ownership rules, stock owned by a partnership is treated as owned by the partner without regard to size of the partner's ownership in the partnership. Also, if a shareholder owns shares with a value of at least 5 percent of the value of all the shares of a corporation (see section 304(c)(3)(B) discussed above), shares owned by the corporation are treated as owned by the shareholder.[29]

To make matters worse, stock can be reattributed for this purpose. For example, if a higher-tier partnership or a corporation owns an indirect interest in shares of a corporation through a lower-tier partnership or corporation, the shares can be reattributed through the tiers of partnership or corporations to other indirect owners through multiple iterations of the indirect ownership rules.[30]

Fourth, it must be determined that Mr. X does not own a *constructive* interest in the foreign acquiring corporation (also within the meaning of section 318(a)). This analysis is also hard, both because it can be combined with the indirect rules under the reattribution rules discussed above and because of the breadth of the constructive ownership rules. Under the constructive ownership rules, options are taken into account. Thus, it must be shown that Mr. X, a former domestic target entity shareholder, does not own an option on shares of the foreign acquiring corporation (which option might be issued by an unrelated shareholder) or an option on an entity that owns a direct or indirect interest in the shares of the acquiring corporation. Also, Mr. X's spouse or other relevant family member might own shares in the foreign acquiring corporation or an interest in an entity that owns a direct or indirect interest in the shares of the acquiring corporation.

The determination of constructive ownership in a private equity transaction can also be difficult because of so-called sweet equity, by which former employees who might have held shares in the domestic entity receive options, warrants, or restricted stock in the acquiring corporation or an affiliate as an incentive for them to continue to provide services to the foreign acquiring corporation. Those incentive rights will be treated as equity under the constructive ownership rules and count against the 5 percent threshold as well.

Fifth, the process has to be repeated for each shareholder other than Mr. X that owns a direct interest in a domestic target. The process is often worse if the shareholder that directly held stock in the domestic entity is not an individual, but rather a corporation or a partnership. In that case, if Mrs. Y is a direct or indirect owner of the foreign acquiring corporation after the transaction, it must be determined whether Mrs. Y is a 5 percent

[28] *See* reg. section 1.7874-2(b)(2) (defining a former shareholder as "any person that *held* stock in the domestic corporation before the acquisition described in section 7874(a)(2)(B)(i)") (emphasis added).

[29] Sections 318(a)(2)(C), 304(c)(3)(B).

[30] Section 318(a)(5)(A).

shareholder in that corporation or a partner in that partnership. If so, her shares in the foreign acquiring corporation could be constructively owned by the corporation or partnership for purposes of determining whether the corporation or partnership is a 5 percent shareholder in the foreign acquiring corporation after the transaction.

Sixth, and finally, the ownership across all the shareholders would have to be aggregated to determine if all former domestic entity shareholders cumulatively owned 5 percent of the foreign acquiring corporation directly, indirectly, or constructively.

Comments on the 2017 final regulations rightly focused on how difficult it was to satisfy the de minimis rule because of the requirement to identify the former domestic target entity shareholders (that is, step one) and then determine their ownership in the foreign acquiring corporation and its affiliates (that is, steps two through six). The preamble noted:

> Other comments requested removing the second requirement of the de minimis exception or, alternatively, modifying the requirement so that it looks only to stock held by reason of holding stock (or interests) of the domestic entity. The comments noted that, particularly in cases involving a publicly-traded domestic entity or a complex ownership structure, it could be difficult or burdensome to *identify* each former domestic entity shareholder or former domestic entity partner (including a de minimis former domestic entity shareholder or former domestic entity partner), as applicable, and then *determine* (taking into account the applicable attribution rules) the former domestic entity shareholders' or former domestic entity partners' collective ownership of the foreign acquiring corporation and each member of the [expanded affiliate group]. [Emphasis added.][31]

The IRS responded to that comment by modifying the second clause so that it had to be demonstrated that no *single* domestic target entity shareholder (rather than all shareholders collectively) owned 5 percent, taking into account the attribution rules. In other words, step six of the above analysis was eliminated so that the shareholder ownership in the foreign acquiring corporation would not be combined and taken into account aggregately, but rather measured only individually.

Thus, it would be acceptable if Mr. X and another former domestic target shareholder owned, taking into account the stock attribution rules, 3 percent of the foreign acquiring corporation each, as long as neither Mr. X nor the other shareholder individually owned — directly, indirectly, or constructively — 5 percent or more of the vote or value of the shares. In the view of the IRS, that change struck "the appropriate balance between preventing the de minimis exceptions from applying in inappropriate circumstances and addressing the practical difficulties noted in the comment."

Raising the permitted cross-ownership did help, but the problem is one of proof; that is, (1) *identifying* "each former domestic entity shareholder or former domestic entity partner" and (2) *determining* "taking into account the applicable attribution rules, the former domestic entity shareholders' or former domestic entity partners' collective ownership of the foreign acquiring corporation and each member of the [expanded affiliate group]." The IRS's change eliminates the requirement that the 5 percent threshold be determined collectively, but given the breadth of the indirect and constructive ownership rules as well as the complexity of private equity structures, it is still difficult to affirmatively demonstrate that any target shareholder, no matter their size of ownership, does not own 5 percent of acquiring (or an affiliate) on a constructive basis. Absent an affirmative declaration from that shareholder, which is generally impractical, there will usually not be enough information about the target shareholder to make that determination.

In the preamble to the 2018 final regulations, the IRS noted that commentators reiterated their "identify" and "determine" complaints that they

[31] T.D. 9812.

had previously made despite the changes to the de minimis rule in the 2017 final regulations:

> Similar to a comment submitted with respect to the disqualified stock rule and addressed in TD 9812, a comment recommended additional modifications to the second requirement. The comment stated that, particularly in *cases involving a publicly-traded domestic entity or a complex ownership structure*, it could be difficult or burdensome to *identify* each former domestic entity shareholder or former domestic entity partner (including a de minimis former domestic entity shareholder or former domestic entity partner), as applicable, and then *determine* (taking into account the applicable attribution rules) the person's ownership of the foreign acquiring corporation and each member of the [expanded affiliate group].
>
> The Treasury Department and the IRS agree that it is appropriate to modify the second requirement in order to make the de minimis exceptions easier for taxpayers to comply with and for the IRS to administer. Accordingly, under the final regulations, only former domestic entity shareholders or former domestic entity partners, as applicable, that own (taking into account the applicable attribution rules) at least five percent of the stock of (or a partnership interest in) the domestic entity need be identified. [Emphasis added.][32]

So the IRS responded by making it easier to identify the relevant former target shareholders by providing that only 5 percent former domestic entity shareholders or 5 percent former domestic entity partners are taken into account for this purpose. The second clause of the de minimis rule was then amended to provide:

> (ii) On the completion date, *each five percent* former domestic entity shareholder *or five percent* former domestic entity partner, *as applicable*, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity. [Emphasis added.][33]

For private equity, there are two important consequences of these changes. First, the IRS changes do simplify step one by making it easier to *identify* the relevant group of domestic shareholders. Previously, all direct shareholders needed to be considered; after the change, only direct shareholders that were 5 percent shareholders (by vote or value and taking into account the attribution rules) need to be considered.[34]

However, in both series of comments, the commentators' point was that it was difficult to *identify* those shareholders and then *determine* their ownership. Although identification was simplified somewhat, the IRS ignored the commentators' point in relation to how difficult it is to determine ownership in a foreign acquiring corporation, especially when there is a complex ownership structure. Thus, the same difficulties exist for determining ownership as existed before, especially regarding the interaction of the complex ownership structures that exist in private equity and the section 318 attribution rules.

Second, in the flurry of all this activity, what is unstated above is that the stakes around the de minimis rule increased significantly. In Notice 2015-79, Treasury and the IRS provided that the

[32] T.D. 9834, IRB 2018-31.

[33] Reg. section 1.7874-4(d)(1).

[34] Reg. section 1.7874-12(a)(13) (defining a former domestic entity shareholder as "any person that *held* stock in the domestic corporation before the domestic entity acquisition") (emphasis added).

de minimis exception would prevent the application of not only the disqualified stock rule but also the NOCD rule. And as noted, in a private equity transaction, both rules have disproportionate effects on the ownership fraction — specifically, the disqualified stock rule generally reduces the fraction to zero over zero, while the NOCD rule inflates both the numerator and denominator. Thus, the stakes had increased because it wasn't just an issue of whether the fraction would be zero over zero (in which case the ownership requirement fraction would be arguably met). Rather, absent satisfaction of the de minimis rule, the NOCD rule would cause the ownership fraction to exceed 80 percent; thus, private equity transactions need to successfully qualify under the de minimis rule to proceed.

V. What Can Be Done to Fix the De Minimis Rule?

Given the stakes around the de minimis rule, it is worth considering the current scope of the exception and whether it can be improved.

A. Evaluation of the Current De Minimis Rule

As discussed, the problematic clause of the de minimis rule is the second one; it is difficult to *identify* the 5 percent former shareholders of the domestic corporation and then *determine* whether any of those shareholders own 5 percent of acquiring or its affiliates, taking into account the constructive ownership rules.

Unlike the first clause of the de minimis rule, the second clause operates without regard to whether the shareholder acquired its ownership in the acquiring corporation "by reason of" its ownership in domestic target entity. Thus, it is particularly susceptible to the complex structure charts of private equity and for the reasons discussed above can result in the application of section 7874 even in all-cash deals in which there is no "by reason of" ownership.

What is the IRS's interest in including the second clause in the de minimis exception? The predecessor for the second clause might have been the section 367(a) regulations, which condition nonrecognition treatment on 5 percent shareholders of the domestic target owning less than 50 percent of the transferee foreign corporation, directly, indirectly, or constructively.[35] When the section 367(a) rule was originally created, the IRS specifically stated that if a transferor could not prove less than 50 percent ownership, it would be deemed to have owned 50 percent for purposes of the rule.[36] It is possible that the same deeming rule might apply for purposes of the de minimis exception, although the IRS has not (to our knowledge) specifically stated that. And as discussed, the deeming rule is much more pernicious when the taxpayer must prove a negative — that 5 percent ownership does not exist under the de minimis rules, as compared with the 50 percent in section 367(a).

It is also possible that the IRS might have been concerned that a taxpayer might do an end run around the "by reason of" rules. For example, a taxpayer could contribute cash or other disqualified property to a foreign acquiring corporation, and he might then transfer his shares in domestic target to the foreign acquiring corporation (or merge domestic target into foreign acquiring) in exchange for that cash. He is now a shareholder in foreign acquiring, without any "by reason of" ownership. And although that "all-cash" transaction might be easily recast into a "by reason of" acquisition, more complicated versions could easily be developed that might be more difficult to recast into a stock acquisition, which creates the need for a clause (ii) to call off the de minimis rule based on the overlapping ownership.

Whatever the motivation for clause (ii), the mistake the IRS made was that if it was going to use a low threshold such as 5 percent to test overlapping ownership, it should have provided additional safeguards to protect taxpayers who cannot accurately make a determination because of the complexity of the ownership structure or the constructive ownership rules.

B. Improving the De Minimis Rule

In at least one situation, the IRS has issued a private letter ruling that a taxpayer satisfied a statute, section 304, that itself depends on a lack of cross-ownership between target and acquiring,

[35] *See r*eg. section 1.367(a)-3(c)(1). The 5 percent ownership threshold was presumably based on the availability of SEC filings to document ownership at that level. Reg. section 1.367(a)-3(c)(5)(iii).

[36] Notice 87-85, 1987-2 C.B. 395.

based on reasonable diligence that was done by the taxpayer.[37] Thus, an acquiring corporation might request a ruling and represent that it undertook reasonable diligence to ensure there is no significant cross-ownership.

Yet, the ruling process is not the solution to that problem for several reasons. First, as a point of observation, the same constructive ownership rules operate for both section 304 and the second clause of section 7874. The relevant control standard for section 304, however, is 50 percent, compared with 5 percent for section 7874. Thus, the degree of difficulty is likely to be greater in a section 7874 transaction than a section 304 transaction, which means many rulings could be sought.

Second, few if any deals are likely to proceed based on an IRS ruling on section 7874. Often, the disqualified stock rule applies because a new foreign acquiring corporation is being formed to acquire the domestic target entity. When faced with the delay, expense, and uncertainty of obtaining a ruling, private equity managers will be forced to form a domestic acquirer instead (or use a passthrough structure), even though the transaction does not implicate the policy concerns section 7874 was meant to address. Thus, it would be preferable for the IRS to amend the regulations to provide flexibility to taxpayers in a manner that still protects its interests. For example, the regulations, like the private letter ruling issued above, could explicitly permit the taxpayer to rely on its reasonable diligence in concluding that the cross-ownership did not exist. Specifically, clause (ii) of the de minimis rule could be amended to add the emphasized language as follows:

> (ii) The *foreign acquiring corporation and each member of the [expanded affiliate group] reasonably believed, that as of* the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group.[38]

The IRS could define reasonable belief as requiring the same steps that the taxpayer was required to take in the section 304 ruling to demonstrate that it had exercised reasonable diligence. Specifically, the foreign acquiring corporation and each member of the expanded affiliate group could be deemed to have a reasonable belief if they comply with the following (which are the representations in the section 304 ruling, appropriately modified for section 7874 purposes):

> As of the completion date (or the closest point in time preceding the completion date for which the relevant information is available) (i) they have performed all means available (that would not be unreasonable, impractical, or unduly burdensome to perform) to (x) identify former five percent former domestic target shareholders and (y) determine such shareholders' ownership (as defined in clause (ii)) in each member of the expanded affiliate and (ii) they do not have actual knowledge that would give them reason to believe that a former five percent domestic target shareholder satisfies that ownership requirement.

C. Analysis of the New De Minimis Rule

If there is in fact a 5 percent former shareholder with cross-ownership (because for example of an unforeseen application of the constructive ownership rules) and that shareholder is not identified by the acquiring corporation's reasonable diligence, it is hard to see how a tax adviser's reliance on the de minimis rule would be problematic for the IRS.

Any "end run" around the "by reason of" rules would certainly be something that should be identified by "reasonable diligence." Under this new rule, reasonable diligence must be done as of the "completion date (or the closest point in time preceding the completion date for which the relevant information is available)." The definition

[37] *See* LTR 202141005 (July 16, 2021).

[38] Reg. section 1.7874-4(d)(1).

of completion date is "the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete."[39]

When there is a "plan or arrangement" — such as a planned redemption/reinvestment by a large shareholder — to avoid "by reason of" ownership, foreign acquiring corporations and their affiliates are almost certain, after the exercise of reasonable diligence, to be aware of the intended cross-ownership, and the revised de minimis rule would not be satisfied. Reasonable diligence would require foreign acquiring to perform all non-burdensome means available to identify the 5 percent shareholders of domestic target and determine their ownership in foreign acquiring corporation. And a redemption/reinvestment plan by a large shareholder would almost certainly require complicity by foreign acquiring corporation and its affiliates who could not reasonably claim ignorance to such an occurrence.

If the overlapping ownership of target and acquiring is not "pursuant to a plan" to avoid the purposes of the rule, reasonable diligence will in most cases identify it as well. In those cases, clause (ii) might prevent some acquisitions that do not raise section 7874 policy concerns, but some overbreadth of the anti-inversion rules is understandable given the abuse they are intended to guard against.

For those reasons, modifying the second clause of the de minimis rule to include a knowledge requirement based on some sort of reasonable diligence should protect the IRS's interest while also avoiding the possibility of so-called phantom inversions in connection with an all-cash purchase. What is more important is that it will give managers confidence that, upon examination, they can assert that they did the appropriate diligence and did not identify the type of cross-ownership contemplated. And they will no longer be required to disprove a negative; that is, they will no longer be in what is often the impossible position of having to show that there is no daisy chain construct of ownership that could cause some 5 percent domestic target shareholder to be viewed as owning 5 percent of the foreign acquiring corporation.[40] ■

[39] Reg. section 1.7874-12(a)(3).

[40] The preceding information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.