NEW YORK STATE BAR ASSOCIATION
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November 20, 2012

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Steven Miller
Acting Commissioner
Internal Revenue Service
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The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Re: Report on Substantial Business Activities Test under Temporary Section 7874 Regulations

Dear Messrs. Mazur, Miller and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association, which comments on the temporary regulations addressing the "substantial business activities" test under Section 7874 of the Code.

By way of background, Section 7874 of the Code imposes adverse tax consequences on certain domestic entities that expatriate to a foreign jurisdiction in an "inversion" transaction. Section 7874 does not apply, however, if the expanded affiliated group which includes the expatriated entity is engaged in substantial business activities in the foreign country of organization relative to its worldwide business activities.

The temporary regulations provide an exclusive bright-line test for determining whether an expatriated entity and its affiliates are engaged in substantial business activities in the relevant jurisdiction, requiring that at least 25 percent of the group's employees, assets, and gross income be located in or derived from such jurisdiction.

Consistent with our prior reports, we continue to believe that a facts and circumstances test with safe harbors would be more appropriate. If final regulations retain an exclusive bright-line test, however, we believe they should define and clarify certain aspects of each component of the three-part test of the temporary regulations and should allow expatriated entities that are clearly engaged in substantial business activities in the relevant jurisdiction to qualify for relief.

A particular source of our concern is the gross income component of the test, which sources income based on the location of the customers rather than the location of the activities that generated the income. As a result, expatriated entities and their affiliates can fail the substantial business activities test even though all their employees and assets are located in the home country and all of their activities are conducted in the home country. For example, a manufacturing company that has all its employees and factories in its home county but exports more than 75 percent of its products would fail the substantial business activities test.

Although we support the customer-based source rule, we believe inversion transactions should qualify for relief under the substantial business activities exception even if they fail any single component of the three-part test so long as the percentage thresholds of the other two components are otherwise substantial. We therefore recommend that, rather than requiring that all three components of the test satisfy the 25 percent threshold, final regulations should require that at least two of the three components satisfy the relevant 25 percent threshold and that the average of all three components equals or exceeds 25 percent.

The report also includes more detailed comments on the components of the bright-line test and the anti-abuse rule in the temporary regulations.

We appreciate your consideration of our report and its recommendations.

Respectfully submitted,

Andrew W. Needham
Chair

Enclosure

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