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In this report, Zhu describes the most important U.S. tax matters that should be considered for a start-up contemplating an offshore structure. He addresses tax issues in the setup phase, including section 351 concerns, questions arising in connection with service-based vesting imposed on the founder stock, and issues under sections 367 and 7874.

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Technology start-ups typically go offshore for at least one of three reasons. First, some non-U.S. investors have a fear, largely unfounded,[1] that investing in a U.S. company will pull them into the U.S. tax net. Second, in terms of exit, offshore companies offer different options for public listing from those available to a U.S. company, and they may also be more attractive to a potential acquirer. A third factor is the desire to reduce the company's U.S. tax when it becomes profitable and has taxable income.[2] Whatever the reason, offshoring is happening.

Yet offshoring a start-up with substantial U.S. tax nexus (by way of customers, target market, employees, investors, or founders) raises an array of U.S. tax concerns that must be balanced against the potential benefits of going offshore. Many start-ups go offshore without adequately evaluating, let alone addressing, those issues. They have a business to start, then to run and to grow, winds of technology shifts to ride, and not enough management bandwidth or experience for tax matters that could be complex or arcane. Problems could fester and grow more costly.

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[1]As compared with many other countries, the U.S. tax regime is favorable to a foreign investor. A foreign investor in a U.S. company that has no other U.S. tax nexus is generally not subject to U.S. tax on capital gains realized from the investment, without the need to resort to a treaty provision. *See* section 864(b)(2)(A) (foreign investors generally are not treated as being engaged in a U.S. trade or business and are not subject to U.S. tax under section 871(b) for foreign individuals and section 882 for foreign corporations); and reg. section 1.1441-2(b)(2)(i) (gains from a sale of property are generally not treated as fixed or determinable annual or periodic income and are not subject to U.S. tax under section 871(a) for foreign individuals and section 881 for foreign corporations). There is also generally no U.S. tax return filing obligation imposed on the foreign investor with such capital gains. *See* reg. section 1.6012-1(b)(1) (for foreign individuals) and -1(g)(1) (for foreign corporations).

(Footnote continued in next column.)

Unless otherwise specified, this report assumes that the start-up is treated as an association taxed as a corporation under the check-the-box rules. Reg. section 301.7701-1 through -3. Offshore companies, all the members of which have limited liability, are taxed as a corporation by default under those rules. Reg. section 301.7701-3(b)(2).

[2]Most acquired start-ups are acquired before they have taxable income. Sometimes, even when the company is in a loss position overall, a cost-plus arrangement among affiliates can result in taxable income for an affiliate.

Insofar as the company's tax structure is of concern to an acquirer, the third reason overlaps with the second. However, a potentially more important tax benefit is that a U.S.-based acquirer with cash in its offshore subsidiaries, which are controlled foreign corporations under section 957(a), could use its offshore cash to acquire the foreign target without having to deal with the deemed repatriation of that cash by a CFC to the U.S. parent. The deemed repatriation, *i.e.*, income inclusion by the parent, arises under sections 951 and 956 when a target is a U.S. corporation. *See* section 951(a)(1)(B) (requiring income inclusion by a U.S. shareholder, as defined in section 951(b), for its share of the section 956 amount); section 956(c)(1)(B) (providing that the section 956 amount includes an amount "with respect to" stock of a domestic corporation owned by a CFC); and reg. section 1.956-1(e) (providing that that amount is generally the adjusted basis in the stock, reduced by any liability other than specific disqualified liability to which the stock is subject).

I. Section 351 and Founder Stock Vesting

A. Section 351

A few section 351 and vesting-related issues often occur for a start-up. The establishment of a start-up is usually tax free under section 351,[3] regardless of whether all the founders are subject to U.S. tax at the time.

Section 351 applies only if the persons that transfer property to a corporation in exchange for its stock are in control of the corporation, within the meaning of section 368(c), immediately after the exchange.[4] For this purpose, control means the ownership of (1) stock representing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and (2) at least 80 percent of the total number of shares of each other class of stock.[5] As noted, the requisite control must exist immediately after the exchange.[6] However, the term ''immediately'' is subject to a step transaction analysis, so the control test is applied immediately after the last of all the transactions that are required to be stepped together for this purpose.[7]

The founders form a start-up by establishing the entity and making contributions to it. Later, venture financing takes place. Sometimes these two events are not far apart. Is the venture financing a part of the same section 351 exchange as the founder contributions? Ordinarily, the founder contributions occur while the venture financing is still sufficiently uncertain, such that the financing should be treated as a separate transaction. But, regardless of whether the founders retain control after the venture financing, the founder contributions should qualify under section 351. If the founder contributions are not stepped together with the venture financing, the founders meet the control test immediately after their contributions. If they are stepped together, the founders and the venture investors together meet the control test immediately after both the founder contributions and the venture financing.[8]

B. Service-Based Vesting

Typically, the founders are expected to continue to contribute to the start-up by way of services. In fact, these services that the founders will provide to a start-up are often a more important contribution than whatever formal consideration they contribute in exchange for the founder stock.[9] This is ordinarily reflected in a service-based vesting condition imposed on the founder stock.

The service component raises several issues. Although stock issued for services is not considered issued for property for section 351 purposes,[10] stock owned by a founder who receives stock both for property and for services — including stock specifically designated as issued for services — all goes toward meeting the control test.[11] If a founder receives stock solely for services and has more than 20 percent of the voting power in the start-up or more than 20 percent of a class of nonvoting stock,[12] after properly addressing whether the venture financing should be included for that purpose, the

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[3]The discussions here do not consider the nonqualified preferred stock rules under section 351(g) or the investment company rules under section 351(e)(1).

[4]Although section 351(a) requires that the exchange of property be solely for stock, boot will not in itself disqualify a section 351 exchange, but may require gain recognition (without permitting loss recognition) by the contributors under section 351(b). The corporation's assumption of a contributor's liability may also require gain recognition under section 357(c). Some liabilities described in section 357(c)(3) are excluded for this purpose.

[5]Section 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

[6]Rev. Rul. 2003-51, 2003-1 C.B. 938.

[7]Reg. section 1.351-1(a)(1) (''The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure''). *See* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 3.09 (2006 and 2014 Supp. no. 2) (discussing the ''immediately after the exchange'' requirement and the application of the step transaction doctrine in this context).

[8]Cash is property for section 351 purposes (*Holstein v. Commissioner*, 23 T.C. 923 (1955)), so the investors are a part of the transferor group.

[9]For a general discussion of, and some complaints about, the taxation of founder stock linked to sweat equity, see Victor Fleischer, ''Taxing Founders' Stock,'' 59 *UCLA L. Rev*. 60 (2011).

[10]Section 351(d)(1); reg. section 1.351-1(a)(1)(i).

[11]Reg. section 1.351-1(a)(2), Example (3). For those that already own stock in the corporation or receive stock for services, de minimis contributions intended solely to bring all their stock toward meeting the control requirement may be subject to challenge. Reg. section 1.351-1(a)(1)(ii) (''Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under [section 351] the exchanges of property by others persons transferring property''). Ten percent would not be treated as de minimis for this purpose. Rev. Proc. 77-37, 1977-2 C.B. 568, section 3.07 (10 percent sufficient for purposes of a private letter ruling).

[12]Care should be taken in counting the voting power. In general, the voting power is likely to be determined by the power to vote for directors, so a founder that can designate, for example, one out of four directors, each of which has an equal vote on the board, might be treated as having 25 percent of the voting power. *See* Bittker and Eustice, *supra* note 7, at para. 3.07[2] (citing Rev. Rul. 66-339, 1966-2 C.B. 274; Rev. Rul. 69-126, 1969-1 C.B. 218; *Hermes Consol. Inc. v. United States*, 14 Cl. Ct. 398 (1988), and *Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999), which address the meaning of voting power in several analogous contexts).

founder will cause the contributions of the other founders to fail to qualify for the tax-free section 351 exchange.

Even if that were to take place, the taxable income to the other founders is generally no more than the fair market value of the founder stock received by them. But the amount could be significant, potentially reaching into the hundreds of thousands of dollars for a start-up valued by reference to a few million dollars of venture financing.[13] In part to avoid that result, founders typically maintain that the founder stock received by each of them is at least in part for property, be it cash, know-how, or more concrete forms of intellectual property.[14]

In fact, the founders usually take a position that goes beyond what is necessary to preserve the overall section 351 qualification. Stock issued for services cannot be received tax free under section 351,[15] and it generally constitutes taxable compensatory income, potentially under section 83 if there is a substantial risk of forfeiture imposed on the stock.[16] For founder stock, the practice is to treat the stock as issued entirely for property and to treat the service-related vesting condition as simply an added shackle on the stock issued in the tax-free exchange.[17]

Although service-based vesting would implicate the section 83 regime and thereby potentially result in ordinary income treatment, the universal practice is for a founder to make the section 83(b) election.[18] In situation 2 of Rev. Rul. 2007-49, 2007-2 C.B. 237, the IRS ruled that a service provider exchanging substantially vested stock of a target for substantially unvested stock of an acquirer in a section 368(a) reorganization is subject to section 83, but that it is able to make an election under section 83(b) with the ''amount paid'' equal to the FMV of the substantially vested stock surrendered. Although not explicitly stated, it is clear that the exchange itself remains tax free under section 354, despite the imposition of the vesting condition.[19] The same analysis should apply when the exchange is a section 351 exchange of substantially vested property for substantially unvested stock.

That the section 354 regime applies to an exchange in a reorganization also subject to section 83 may be seen most clearly in the treatment of basis in situation 2 of the revenue ruling. Rev. Rul. 2007-49 states that the ''amount paid'' in the section 83(b) election is the FMV of the stock surrendered. Reg. section 1.83-2(a) provides that the basis of the acquirer stock received that is the subject of the section 83(b) election ''shall be the amount paid,'' increased by the amount included in gross income upon the election. But the revenue ruling does not adopt this seemingly applicable but clearly inappropriate rule. Instead, it follows the rule for a section 354 exchange and states that the basis of the acquirer stock is the service provider's historical basis in the target stock surrendered.[20]

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[13]For a general discussion on venture financing and founder compensation, see Ronald J. Gilson and David M. Schizer, ''Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock,'' 116 *Harv. L. Rev*. 874, 889-901 (2002).

[14]*See, e.g.*, Rev. Rul. 64-56, 1964-1 C.B. 133 (ruling that manufacturing know-how is property under section 351); and reg. section 1.351-1(a)(2), Example (1) (stating that patent rights are property, without distinguishing whether the transferor's personal efforts created the patent rights).

Nominal cash is not insignificant, both because the FMV of the stock in the start-up could itself be nominal and because it serves as a benchmark when different founders pay the same per-share price for the founder stock but contribute differently in services by, for example, assuming different roles in the company.

When founders set out to form a start-up, taxable income in the tens of thousands of dollars could be a significant burden — despite the media's tendency to highlight the instant riches of the Wild West variety upon a successful exit — and a tax adviser must be sensitive to that burden as a matter of planning.

[15]Section 351(a) and (d)(1).

[16]Section 83(a), (b), and (c)(1). As a result of the applicability of section 83, that founder stock is generally eligible for the short-term deferral exception to the section 409A rules. Reg. section 1.409A-1(b)(4).

An offshore start-up is often a nonqualified entity under section 457A, but the section 457A rules are unlikely to apply to founder stock subject to typical service-based vesting terms. Any such vesting requirement is generally a substantial risk of forfeiture under both section 457A (see section 457A(d)(3)(B) and Notice 2009-8, 2009-4 IRB 347, Q&A-3) and section 83 (see section 83(c)(1) and reg. section 1.83-3(c)), even though the scope of the term ''substantial risk of forfeiture'' is narrower under section 457A. If vesting for section 83 purposes occurs at the same time as (or before) vesting for section 457A purposes, the founder stock issuance is eligible for the short-term deferral exception to the section 457A rules. *See* section 457A(d)(3)(B)

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and Notice 2009-8, Q&A-2(c) and 4. *See also* Rev. Rul. 2014-18, 2014-26 IRB 1104 (amplifying Notice 2009-8 and providing that stock appreciation rights that must be settled in service recipient stock and with an exercise price no less than the FMV of the stock on the date of the grant are not a nonqualified deferred compensation plan subject to section 457A because section 83 applies to the settlement).

[17]This position, if correct, avoids the need to determine whether the stock issued to a founder for property is of relatively small value compared with stock issued for services. Reg. section 1.351-1(a)(1)(ii).

[18]Section 83(b); reg. section 1.83-2.

[19]*Compare* Rev. Rul. 2007-49, 2007-2 C.B. 237, situation 2 (the exchange itself is a part of a section 368(a) reorganization) *with* situation 3 (the exchange itself is a part of a taxable sale of the target).

[20]Section 358(a)(1). The ruling's conclusion is clearly correct. The section 83(b) rule is premised on an assumption, albeit unstated, that if the amount paid is in the form of an appreciated property, it would be treated as a satisfaction of a liability of the

(Footnote continued on next page.)

Sometimes a founder that is not a U.S. taxpayer at the time of founding later becomes one. Because the section 83(b) election must be made no later than 30 days after the date of the section 351 exchange,[21] a founder that lacked the clairvoyance to make the section 83(b) election at the time of founding may be unable to make that election when the need arises. In a private letter ruling, the IRS has taken the position that in that case, the section 83(a) regime applies and that if the founder is a U.S. tax resident on the date of vesting, it is taxed on all the income as if it were a U.S. citizen.[22]

For a founder that did have the clairvoyance, it may be difficult to comply with all the mechanical requirements of a valid election. In describing the manner of making the section 83(b) election, the regulations state that a copy of the election must be filed with the IRS office with which the founder files the income tax return, and that another copy must be submitted with the income tax return for the tax year in which the section 351 exchange occurs.[23] Also, the election statement must include the founder's taxpayer identification number.[24] What is a founder that is not subject to U.S. tax and does not file any U.S. tax return at the time of the intended election to do? In a phone conversation, an attorney at the IRS National Office suggested that (1) the founder file the election with all the required information other than the TIN and attach a cover letter describing the circumstances, including why the TIN is unavailable; (2) the election be supplemented with the TIN if the founder later becomes a U.S. taxpayer; (3) the requirement that a copy of the election be attached to the income tax return for the year of the exchange does not apply if the founder is not required to file that return for that year; and (4) the founder retain all the documentation in case a question arises later about whether the election was timely and properly made. That may be the best one can do.

II. Section 367(a)

A. Gain Recognition

We now consider that the start-up is offshore,[25] which triggers section 367. Section 367(a) preserves the section 351 framework[26] but generally requires gain recognition if a U.S. person contributes property to a foreign corporation.[27]

Three comments are in order regarding section 367(a). First, section 367(a) is a one-way ratchet — requiring recognition of gain but prohibiting recognition of loss — with each asset being treated separately and with no offset across assets.[28] This result is substantially worse for a U.S. transferor than it would have been if the transfer simply failed the requirements of section 351.[29]

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service provider with that appreciated property and would therefore result in a taxable exchange of the property. Section 1001; reg. section 1.1001-2 (amount realized in an exchange including liability discharged).

The ruling does not provide explicit guidance regarding the holding period, but the general rule of section 1223 should apply, and the acquirer stock received should have a tacked holding period, including the holding period of the target stock surrendered. Section 1223(1). The same rule should apply when property is exchanged in a section 351 exchange. The silence of the ruling in this regard is understandable. Section 83(f) and reg. section 1.83-4(a) appear to require that the holding period of the acquirer stock begin just after the date that stock is transferred. Having brought situation 2 within the scope of section 83, the IRS may have believed it did not need to directly contradict section 83 and its regulations regarding the holding period. In contrast, express deviation from the regulations regarding basis cannot be avoided in order to prevent some taxpayers from invoking the regulations and taking an FMV basis in acquirer stock in situation 2.

[21]Section 83(b); reg. section 1.83-2(b). If the founder stock was not subject to vesting on initial founding but service-based vesting was later imposed on a round of financing in a separate transaction, the subsequent imposition of vesting does not give rise to a transfer of property under section 83 and does not cause that stock to be subject to section 83(a) on vesting. Rev. Rul. 2007-49, situation 1. Any such vesting imposed on the founder stock under these facts should also not result in a nonqualified deferred compensation plan under section 409A or section 457A. There is neither compensation nor deferral when vesting is imposed on founder stock that is already fully vested.

[22]LTR 8711107.

[23]Reg. section 1.83-2(c). *But see* LTR 201438006 (a section 83(b) election does not fail solely because of a failure to submit a copy of the election with the income tax return for the year of the transfer).

[24]Reg. section 1.83-2(e)(1). Some founders who are ineligible to use a Social Security number as the TIN apply for an individual taxpayer identification number (ITIN) solely to make the election. But it is unclear that a founder in this situation is eligible to receive an ITIN (see Instructions for Form W-7, at 7-9 (exceptions tables) (Rev. Aug. 2013)), and unless applied for sufficiently before the section 351 exchange, the ITIN may not be available within the 30-day window prescribed for the section 83(b) election.

(Footnote continued in next column.)

[25]One tax disadvantage for offshoring is that stock in an offshore start-up cannot be qualified small business stock (QSBS) under section 1202. Section 1202(c)(1)(A) and (d)(1). For QSBS purposes, founder stock issued for services would otherwise qualify. Section 1202(c)(1)(B)(ii).

[26]Reg. section 1.367(a)-1(b)(4)(i)(C) (A section 351 transfer "will not be recharacterized as other than an exchange described in section 351 solely because the U.S. person recognizes gain in the transfer under section 367").

[27]Section 367(a).

[28]Reg. section 1.367(a)-1T(b)(1) and -1T(b)(3).

[29]The only consolation is the gain limitation rule, under which the total gain required to be recognized will not exceed the gain that would have been required to be recognized "on a taxable sale of those items of property if sold individually and without offsetting individual losses against individual gains." Reg. section 1.367(a)-1T(b)(3)(i). This rule applies to the taxpayer's benefit in the foreign branch recapture rules, when the gain

(Footnote continued on next page.)

Second, section 367(a)(3) excepts from the gain recognition rule transfers of specified property used in the active conduct of a trade or business outside the United States.[30] The exception has several requirements, three of which are particularly relevant to a start-up.[31] One, the transferee must have a trade or business.[32] While the term ''trade or business'' is defined by reference to all the facts and circumstances, the regulations require that the group of activities ''ordinarily include the collection of income and the payment of expenses'' in order to constitute a trade or business.[33] Pre-customer start-ups may have trouble meeting the collection of income requirement if it is applied literally without the ''ordinarily'' qualifier. Yet, ''ordinarily'' suggests not always, and it would appear that a start-up that is pre-revenue but engaged in (albeit commencing) a trade or business under section 162 should not fail to be treated as being engaged in a trade or business for this purpose solely because it is pre-revenue.[34] Two, the transferee must actively conduct the trade or business.[35] The regulation states, ''In general, a corporation actively conducts a trade or business *only if* the officers and employees of the corporation carry out substantial managerial and operational activities.''[36] But for the important rule discussed below, offshore start-ups would often fail this requirement. Three, as further described below, some property — especially intangible property under section 936(h)(3)(B) — is subject to a different set of rules. Even if the requirements for the exception are otherwise met, that property is ineligible.[37]

An important rule makes this exception more relevant for a start-up than it otherwise would be. In determining whether the requirements are met for the exception, successive transfers by a transferee corporation, which are themselves generally not subject to section 367(a) because the transferor in a successive transfer is no longer a U.S. person, will not invalidate the exception for the initial transfer if (1) the subsequent transfers are described in section 351 or 721; (2) each subsequent transferee is either a partnership in which the preceding transferor is a general partner or a corporation in which the preceding transferor owns common stock; and (3) the ultimate transferee uses the property in the active conduct of a trade or business outside the United States.[38] This is an important rule because many or most offshore start-ups are organized as holding companies with a parent located in a jurisdiction with no or very limited operating activities.

As detailed below, a third consideration regarding gain recognition under section 367(a) is the basis and holding period of the start-up stock received by the founders.

B. Basis and Holding Period of Founder Stock

It may help to summarize the familiar basis and holding period rules for a section 351 exchange without the section 367(a) gain recognition. As to basis, if a founder exchanges a property for one share of the start-up stock, the share of stock will have the same basis as that of the property exchanged.[39] As to the holding period, section 1223(1) provides for tacking treatment if ''the property

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recognized could otherwise be greater than the gain from a sale because of the requirement to recapture all prior branch losses. Reg. section 1.367(a)-6T(a), -6T(b), and -6T(c)(2).

[30]Section 367(a)(3); reg. section 1.367(a)-2T(a). This exception does not apply to the extent the foreign branch recapture rules apply. Section 367(a)(3)(C); reg. section 1.367(a)-6T(b)(2). For special rules regarding leasing an aircraft or vessel in foreign commerce, which are rarely relevant to a technology start-up, see reg. section 1.367(a)-2(e).

[31]Other requirements include that the trade or business be conducted outside the United States (reg. section 1.367(a)-2T(b)(4)) and that the property be used or held for use in the trade or business (reg. section 1.367(a)-2T(b)(5)).

[32]Reg. section 1.367(a)-2T(a)(2).

[33]*Id.*

[34]The trade or business standard under section 162 may be less stringent than that under the section 367(a) regulations, but it is still based on the facts and circumstances and is therefore uncertain. Some authorities under section 162 appear to require the commencement of revenue-generating operations for a taxpayer to be treated as carrying on a trade or business under section 162. *See Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965); Rev. Rul. 81-150, 1981-1 C.B. 119. Others expressly reject this requirement. *See Blitzer v. United States*, 684 F.2d 874 (Cl. Ct. 1982) (citing *Commissioner v. Tellier*, 383 U.S. 687 (1960), and *United States v. Gilmore*, 372 U.S. 39 (1963), as standing for the proposition that the trade or business requirement in section 162 is to exclude personal or family expenses). *Compare* section 195 (excluding from deductible section 162 expenses some start-up expenditures that are clearly not personal or family expenses), *with Snow v. Commissioner*, 416 U.S. 500 (1974) (holding that pre-operational research or experimental expenditures of a business are incurred in connection with a trade or business under section 174).

[35]Reg. section 1.367(a)-2T(b)(3).

[36]*Id.* (emphasis added).

[37]Section 367(a)(3)(B); reg. section 1.367(a)-5T.

[38]Reg. section 1.367(a)-2T(c)(2).

[39]Section 358(a)(1). The basis will be increased by the amount of any gain recognized. Section 358(a)(1)(B).

Under section 362(e)(2)(C), a transferor may, together with the transferee corporation, elect to reduce its basis in the stock received in a section 351 exchange if the transferee corporation will otherwise receive property with an aggregate adjusted tax basis in excess of the FMV and will therefore, in the absence of the election, be required to reduce the aggregate adjusted basis for the property to its FMV. Section 362(e)(2)(C); reg. section 1.362-4(d). Some transfers outside the United States requiring that neither the transferor nor the transferee be a U.S. person, a person otherwise required to file a U.S. return for the year of the transfer, a CFC, or a controlled foreign partnership as defined in reg. section 1.362-4(g)(7), are not subject to section 362(e)(2).

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received in an exchange has . . . the same basis in whole or in part . . . as the property exchanged, and . . . the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231.'' For this purpose, ''in whole or in part'' is generally taken to mean ''determined *by reference to*.''[40]

When multiple assets with different bases and holding periods are contributed to a corporation in exchange for stock in a section 351 exchange, the designation of separate blocks of stock for each property is not permitted under current law.[41] Instead, the aggregate basis of all those assets is allocated among all stock received in proportion to the FMV of the respective stock, and each share of stock received has a split holding period and a split basis for purposes of determining long-term or short-term gain or loss.[42] The split holding period applies not only when the contributed assets have different holding periods in the hands of the transferor, but also when the contributed assets are not assets eligible for the tacking treatment under section 1223.[43]

Within the framework of these rules, section 367(a) raises a difficult problem. As a general matter, section 367(a) requires full gain recognition on a property-by-property basis. The impact on basis as a result of the gain recognition is easy to state. Because section 351 and therefore section 358 apply,[44] the basis of the start-up stock is the same as the basis of the property contributed, increased by

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Reg. section 1.362-4(c)(2). Each transferor is treated separately for purposes of section 362(e)(2)(C). Reg. section 1.362-4(b) (last sentence).

If there is so-called loss importation, the election is unavailable and the transferee corporation must instead adjust the basis of each property received in the section 351 exchange to its FMV (regardless of whether the property has a built-in gain or built-in loss at the time of the transfer). Loss importation occurs if (1) gain or loss on the property is not subject to tax in the hands of the transferor immediately before the exchange, but gain or loss on the property is subject to tax in the hands of the transferee immediately after the exchange; and (2) taking all that property together, the transferee's aggregate adjusted basis in the property would otherwise exceed the FMV. Section 362(e)(1); prop. reg. section 1.362-3. Taxpayers may elect to apply the proposed regulations issued under section 362(e)(1) to transactions occurring after October 22, 2004. Prop. reg. section 1.362-3(g). All transferors transferring importation property are aggregated for purposes of applying section 362(e)(1). Prop. reg. section 1.362-3(c)(3).

[40]Bittker and Eustice, *supra* note 7, at 3-61 (emphasis in the original).

[41]Rev. Rul. 85-164, 1985-2 C.B. 117. *Compare* reg. section 1.358-2(b) (not permitting designation even when multiple classes of stock are received in a section 351 exchange), *with* reg. section 1.358-2(a)(2)(ii) (permitting designation in a section 354, 355, or 356 exchange). *See also* reg. section 1.358-2(a)(2)(viii) (providing overlapping rules). *But see* prop. reg. section 1.358-2(g)(2) and -2(i), examples (16) and (17) (permitting basis tracing in section 351 exchanges when no liability is assumed). Those regulations have not been issued in final form and are not effective.

[42]Rev. Rul. 85-164, 1985-2 C.B. 117.

[43]Section 1223(1). Stock received for assets that are neither capital nor section 1231 property is ineligible for the tacked holding period, even if the assets are property under section 351 and therefore are eligible for the tax-free exchange under section 351 and the exchange basis treatment under section 358.

(Footnote continued in next column.)

One such asset is a copyright or similar property ''held by a taxpayer whose personal efforts created'' it. Section 1221(a)(3)(A). The term ''similar property'' includes ''any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected *only* under the patent law and not under the copyright law'' (emphasis added). Reg. section 1.1221-1(c)(1). A person ''who merely has administrative control . . . and who does not substantially engage in the direction and guidance of [the] persons in the performance of their work'' does not create that property by his personal efforts. Reg. section 1.1221-1(c)(3).

For technology start-ups, computer software created by the personal efforts of a founder would be such an asset, unless it is section 1231 property. Any such computer software is generally subject to depreciation under section 167 (section 167(f)(1)(A)) and not section 197 (section 197(c)(2); reg. section 1.197-2(c)(2)), although amortizable section 197 intangibles are treated as property of a character subject to section 167 depreciation allowance (section 197(f)(7)). So the software should meet the subject-to-section-167-depreciation requirement for section 1231 property. Section 1231(b)(1). But to constitute section 1231 property, the software must also have been held for more than one year. *Id.* For this purpose, the holding period likely begins when the software has been placed in service (Rev. Proc. 2000-50, 2000-2 C.B. 601, section 5.01(2)) or ''reduced to practice'' (*cf.* reg. section 1.1235-2(e)). As a result, work-in-progress software contributed by a founder may not meet the holding period requirement and therefore may not be section 1231 property.

Because of the similarities between software development costs and research and experimental expenditures under section 174, the IRS has administratively allowed a taxpayer to elect to (1) currently deduct the software development costs, in accordance with the rules under section 174(a); (2) capitalize and amortize those costs over a period of 60 months from the date of completion of the development, in accordance with the rules under section 174(b); or (3) capitalize and amortize the costs over a period of 36 months from the date the software is placed in service, in accordance with the rules under section 167(f)(1). Rev. Proc. 2000-50, section 5.

[44]Reg. section 1.367(a)-1(b)(4)(i)(C). There is no doubt that the section 351 treatment applies, despite the gain recognition. ''If a U.S. person transfers [assets] to a foreign corporation in an exchange described in section 351, the transfer is not recharacterized as other than an exchange described in section 351 solely because the U.S. person recognizes gain in the transfer under section 367(a)(1).'' The final regulations with this specific instruction were issued in 2013. T.D. 9614. But the 2008 proposed regulations say that this is a ''clarification'' and not a new rule. Preamble to REG-209006-89. The basic premise underlying section 367(a) has always been that ''the foreign corporation shall not be considered to be a corporation for purposes of determining the extent to which gain shall be recognized on the transfer'' (reg. section 1.367(a)-1T(b)(1)), and not for any other purpose. *See* section 367(a)(1).

the gain recognized.[45] Because the gain is recognized in full, however, this approach yields the same result as the full FMV basis if only gain properties are contributed, and in that sense it cannot be distinguished from a direct mark-to-FMV approach.

But these two approaches could lead to different results for holding periods. If the stock basis is viewed as directly marked to FMV and may therefore no longer be determined by reference to the basis of the property exchanged, the holding period would start anew.[46] However, if the section 358 approach is taken seriously, as required by the regulations, determining the basis of the stock received begins with the basis of the contributed property, and the holding period should likely tack.

I believe that the latter view is the better one for four reasons.[47] First, it should be emphasized that section 367(a) preserves the section 351 structure, and its scope is specifically limited to gain recognition. In light of the specific statutory language and the even more specific regulatory language, we should hesitate to extend the effect of section 367(a) to a collateral matter that, although closely related to gain recognition, is nevertheless beyond the specified scope.

Within the section 351 structure, there are only two types of property that a founder could receive: nonrecognition property and boot. The basis of nonrecognition property is determined under section 358(a)(1), and that determination begins with the basis of the property exchanged.[48] The basis of boot is its FMV,[49] and that determination does not begin with the basis of the property exchanged. Yet despite the gain recognition under section 367(a), stock received in exchange for property contributed by a founder cannot be boot. If some properties contributed by a founder are gain properties and some are loss properties, the boot treatment for stock exchanged for gain property is inconsistent with the no-tracing rule.[50] Even if all the properties contributed by a founder are gain properties, the boot treatment would cause the founder to receive no nonrecognition property, and it would undermine the requirement that the transaction be treated as a section 351 exchange. If the founder stock is not boot under section 358, it must be nonrecognition property under section 358 and should be given the same treatment that generally applies to nonrecognition property.

Second, the gain recognition under section 367 is similar to the gain recognition required under section 356 in reorganizations, and that similarity supports tacking here as well. If an acquirer acquires a target in a section 368 organization and target shareholders receive acquirer stock in exchange for target stock, the exchange is tax free under section 354. If a target shareholder also receives boot, section 356 requires gain recognition to the extent of the boot received.[51] If the amount of the boot equals or exceeds the gain, the target shareholder will always have an FMV basis in acquirer stock under section 358.[52] Nevertheless, the target shareholder has a tacked holding period in the acquirer stock. For the same reason, an FMV-marked basis arrived at by section 358 should also not preclude tacking of the holding period in a section 351 exchange subject to section 367(a).[53]

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[45]Section 358(a)(1)(B)(ii).

[46]*See, e.g.*, Bittker and Eustice, *supra* note 7, at para. 3.10[4] (If ''the transferor's gain is fully recognized, the basis of the stock is its [FMV] at the time of the exchange and hence is not determined in whole or in part by reference to the basis of the transferred property'').

[47]For the same reasons, I believe the holding period should tack, even if the property transferred includes property that is subject to the special recapture rules of reg. section 1.367(a)-4T(b)(1) (treating some U.S. depreciated property as if sold at its FMV, even if it otherwise is excepted from section 367(a)(1)). Also for the same reasons, I believe that the holding period should tack for shares received in a reorganization that is subject to tax because of section 367(a), including by reason of reg. section 1.367(a)-3.

[48]Section 358(a)(1).

[49]Section 358(a)(2).

[50]Although this argument might not apply to a section 354 exchange that allows tracing (or may cease to apply if tracing becomes allowed for a section 351 exchange), I do not believe that the conclusion would be different for a section 354 exchange that is subject to section 367(a) (or for a section 351 exchange that is subject to section 367(a) merely because tracing becomes allowed).

[51]A portion of the gain could be treated as dividend. Section 356(a)(2).

[52]Section 358. Assume a target stockholder has a $70 basis in target stock with an FMV of $80 and receives $12 cash and acquirer stock with an FMV of $68. The stockholder recognizes the full amount of gain, which is $10 (a portion of which may be treated as dividend). The stockholder's basis in acquirer stock received is $70 (section 358(a)(1)), decreased by $12 (section 358(a)(1)(A)), and increased by $10 (section 358(a)(1)(B)), which is $68 — precisely the FMV of the acquirer stock received.

This result is not a numerical coincidence. Because the entire gain in target stock is recognized, the target stockholder has no further gain or loss if it were to sell the acquirer stock immediately after the reorganization. As a result, the target stockholder's acquirer stock must have a basis equal to its FMV immediately following the full gain recognition.

[53]The section 358 basis rules apply also to a section 351 exchange in which the transferor receives boot when gain recognition is also limited by the amount of boot. Section 351(b). The same argument here applies to a section 351 exchange not implicating section 367, but with boot in excess of the amount of gain. *But see* Bittker and Eustice, *supra* note 7, at para. 3.10[4].

There is another example in which an FMV basis does not appear to prevent holding period tacking: If an election is made under section 362(e)(2)(C) in an exchange subject to section

(Footnote continued on next page.)

Third, *Citizen's National Bank v. United States* lends considerable support for tacking.[54] In that case, which addresses a highly analogous issue, the Fifth Circuit concluded that the holding period tacks even as the basis of the property received is, as a practical matter, marked to an amount that does not relate to the basis of the property surrendered. *Citizen's National Bank* involved a settlor that transferred to a trustee stock valued at $714,601, with a basis of $498,468 and subject to a $500,000 debt. The trustee soon sold the stock, and the holding period of the stock in the trustee's hands became an issue. Section 1223(2) provides that if the trustee's basis in the stock is determined in whole or in part by reference to the settlor's basis in the stock, the holding period tacks.[55] The trustee's basis is determined by section 1015, which closely parallels section 358. Section 1015 provides that the trustee's basis is the same as the settlor's, but it is increased by the amount of gain recognized by the settlor.[56] The IRS argued that under the section 1015 regulations, the trustee's basis under these facts is the same as the assumed liability and would not depend on the settlor's basis. The court disagreed. It stated that the basis, while ultimately equal to the assumed liability, is nevertheless arrived at by starting with the settlor's basis and adding to it the gain realized by the settlor. That starting point is sufficient to allow the trustee to tack the holding period.

Fourth, and finally, in at least the following technical scene, the basis of the stock is determined by reference to the basis of the assets contributed, and the holding period should tack. In contrast to a section 1001 exchange, section 367(a) requires gain recognition but does not permit loss recognition. If the basis exceeded the FMV, section 367(a) would not be operative. A determination that there is section 367(a) gain is itself based on a comparison between the FMV of the contributed property and its basis, and in that sense the stock's basis is determined by reference to the basis of the assets contributed.[57]

III. Section 367(d)

A. The Super-Royalty Rules

Section 367(d) replaces the gain recognition rules of section 367(a) with the so-called super-royalty rules. Under section 367(d), if a U.S. person transfers any section 936(h)(3)(B) intangible property to a foreign corporation in a section 351 exchange, the U.S. person will generally be treated as having sold that property for payments that are contingent on the productivity, use, or disposition of the property and that extend over its entire useful life.[58] The temporary regulation says that the U.S. transferor will be treated as receiving those payments, regardless of whether they are in fact made by the transferee.[59] It also says that "amounts so included in the transferor's income shall be treated as ordinary income from sources within the United States,"[60] which is generally undesirable in terms of both character and foreign tax credit treatment.[61] The regulation adds that "in general, deemed annual . . . payments will continue if a transfer is [later] made to a related person, while gain must be recognized immediately if the transfer is to an unrelated person."[62]

Three comments are in order here. First, for purposes of section 367(d), the term "intangible property" means "knowledge, rights, documents, and any other intangible item within the meaning of section 936(h)(3)(B) that constitutes property for purposes of section 351" within the start-up formation context.[63] Section 936(h)(3)(B) defines intangible property to include patents, know-how, copyrights, trade or brand names, licenses, contracts, and customer lists that have "substantial

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362(e)(2), and the transferor's basis in the stock received is therefore marked by its FMV, basis should still tack for the transferor.

[54] 417 F.2d 675 (5th Cir. 1969). The IRS has indicated that it disagrees with the holding in *Citizen's National Bank*. LTR 7752001. The primary reason for the disagreement appears to be that the IRS does not believe that the court's analysis should apply to a transaction that is treated as a sale (albeit to a trust) and not treated as a gift. The IRS is troubled that the court's conclusion may not be limited to a sale within the trust context only. It also appears that the IRS is troubled by the court's willingness to hold that the section 1015 regulations are invalid. However, the private letter ruling fails to acknowledge that the court in *Citizen's National Bank* only held the regulations to be invalid to the extent they prevent the holding period tacking.

In the start-up setting, there is no need to hold any regulations invalid to permit tacking. To the contrary, the regulations go some ways toward clearly limiting the scope of section 367 to gain recognition and seem to indicate that the collateral issues such as holding period should be determined under the normal rules that apply to a section 351 exchange.

[55] Section 1223(2).

[56] Section 1015(a) and (b).

[57] Whether or not it proves too much, the argument has particular applicability in the section 367 setting in which the regulations expressly state that the overall section 351 regime applies other than for the amount of gain recognized under the section 367 regime.

[58] Section 367(d)(2)(A); reg. section 1.367(d)-1T(a). The amount of the deemed payment is generally determined under the transfer pricing rules of section 482. Reg. section 1.367(d)-1T(c)(1).

[59] Reg. section 1.367(d)-1T(a).

[60] Reg. section 1.367(d)-1T(c)(1).

[61] Section 904(a).

[62] Reg. section 1.367(d)-1T(a).

[63] Section 367(d)(1); reg. section 1.367(d)-1T(b) and 1.367(a)-1T(d)(5)(i).

value independent of the services of any individual.''[64] Despite the breadth of that definition, a founder's knowledge and know-how, and possibly even some software programs that lack substantial value unless the founder provides services, appear to be outside its scope.[65]

Second, a U.S. transferor may elect to treat the section 367(d) transfer as a sale[66] if either the intangible property is an operating intangible under reg. section 1.367(a)-1T(d)(5)(ii)[67] or the conditions for the joint venture exception are met. The conditions include:

- the intangible property is transferred to the foreign corporation within three months of the corporation's organization and as part of the corporation's original plan of capitalization;
- the U.S. transferor owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation, and at least 40 percent of the total voting power and value of the foreign corporation is owned by foreign persons unrelated to the U.S. person immediately after the transfer;
- intangible property constitutes at least 50 percent of the FMV of the property transferred by the U.S. transferor to the foreign corporation; and
- the transferred intangible property will be used in the active conduct of a trade or business outside the United States (within the meaning of reg. section 1.367(a)-2T) and will not be used in connection with the manufacture or sale of products in or for use or consumption in the United States.[68]

The exception is useful to a U.S. transferor forming a more or less equal equity joint venture with an unrelated foreign partner, but a U.S. founder of a start-up is typically unable to meet all the requirements. For example, the seeming requirement that these conditions be met by a single U.S. transferor — wholly sensible in a two-party joint venture context — presents significant difficulties for most start-ups.

Third, the regulations expressly prohibit one possible work-around. A founder may seek to transfer an intangible to a domestic corporation and thereafter transfer the stock of the domestic corporation to an offshore start-up. Although the subsequent stock transfer might be taxable,[69] the founder might not be subject to section 367(d) on the intangible transferred to a U.S. corporation and not a foreign corporation. However, if a U.S. transferor transfers the intangible property to a domestic corporation with a principal purpose of avoiding section 367(d) and thereafter transfers the stock of the domestic corporation to a related foreign corporation, the U.S. person will, solely for purposes of section 367(d), be treated as having transferred the intangible property directly to the foreign corporation.[70] Although this antiabuse rule clearly applies

[64]Section 936(h)(3)(B).

[65]Typically, a start-up on initial founding has such limited value that any value placed on the founder stock issued in exchange for knowledge and know-how is unlikely to be substantial.

Two carveouts are excluded from the term ''intangible property'' for section 367(d): (1) foreign goodwill or going concern value (including the value to use a corporate name in a foreign country) (reg. section 1.367(d)-1T(b) and 1.367(a)-1T(d)(5)(iii)); and (2) some copyright and other similar items in the hands of a taxpayer whose personal efforts created that property or who received it from the foregoing creator in a wholly or partially tax-free transaction (reg. section 1.367(d)-1T(b) and 1.367(a)-5T(b)(2)). The second type of intangible property carved out here may include some software programs but is subject to the general gain recognition rule of section 367(a)(1) (reg. section 1.367(d)-1T(b)) and is ineligible for the active trade or business exception to the rule (reg. section 1.367(a)-5T(a)).

[66]In the event of that election, the stock received may not have a tacked holding period.

[67]Reg. section 1.367(d)-1T(g)(2)(i). An operating intangible is ''any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of that property, [such as] long-term purchase or supply contracts, surveys, studies and customer lists.'' Reg. section 1.367(a)-1T(d)(5)(ii). Transfers compelled by the relevant foreign government, including by way of a genuine threat of immediate expropriation, also qualify. Reg. section 1.367(d)-1T(g)(2)(ii).

[68]Reg. section 1.367(d)-1T(g)(2)(iii).

[69]Prearranged successive section 351 exchanges by a transferor do not disqualify the initial section 351 exchange even if the transferors in that exchange do not retain indirect control over that particular transferee corporation at the end of the successive exchanges. Rev. Rul. 2003-51.

Reg. section 1.367(a)-3(c) will probably require gain recognition on the stock transfer because the start-up transferee is unlikely to meet the active trade or business test required for the stock transfer to be tax free. Reg. section 1.367(a)-3(c)(1)(iv) and -3(c)(3)(i)(A) (requiring that the transferee be engaged in an active trade or business outside the United States for the entire 36-month period immediately before the transfer).

[70]Reg. section 1.367(d)-1T(g)(6). The principal purpose requirement is presumed to be met if the intangible transfer is less than two years before the stock transfer. *Id.* Other than perhaps in reorganizations, the IRS tends not to reorder steps of a transaction in applying the step transaction doctrine if each step has independent nontax significance.

For this purpose, the domestic corporation and the start-up transferee are related if they are related under section 267(b), (c), and (f), but with the threshold lowered from ''more than 50 percent'' to ''10 percent or more.'' Reg. section 1.367(d)-1T(h). It would appear that the fact that the domestic corporation and the start-up transferee may have been unrelated before the stock transfer is insufficient to avoid this antiabuse rule. *Id.* (heading); *cf.* reg. section 1.267(f)-1(h) (prohibiting timing distortions to avoid section 267(f)). *But see* section 7806(b) (descriptive matters regarding the contents of the code such as a heading are not to be given any legal effect).

when both the initial intangible transfer and the later stock transfer are section 351 exchanges and the principal purpose requirement is met, the regulations refer to transfers without further elaboration. Thus, they could arguably be construed to apply to other transfers, possibly including an outright sale.[71]

B. Avoiding the Super-Royalty Rules

Because the section 367(d) treatment is severely adverse to a taxpayer conceptually and highly uncertain quantitatively, there is often a desire to avoid it. The following two approaches are often considered. Both use the fact that the applicability of section 367(d) is predicated on the applicability of section 351 in the start-up formation. Therefore, if section 351 can be avoided, so can section 367(d).

Under the first approach, instead of structuring the contribution as part of a section 351 exchange, a founder may license the intangibles explicitly for royalty payments or sell them outright to the start-up.[72] In a start-up, a sale is almost always preferable for two reasons. One is that the total value of the start-up with those intangibles is often limited. An outright sale, which can produce capital gain instead of ordinary income, tends to have few actual income tax consequences. A sale also avoids the need to determine the appropriate royalty schedule and starts the statute of limitations for the transfer. Another reason a sale is usually preferable is that a start-up seeking venture financing typically does not wish to have a standing royalty obligation to a founder.[73]

Any sale is subject to recharacterization as either a section 351 exchange with boot or, if the sale occurs in connection with the establishment of the start-up to which the seller separately contributes cash for founder stock, as an outright exchange of the intangible for start-up stock.[74]

Under the second approach, the founders may structure the entire exchange to fail the section 351 control requirement. This could be done either by issuing to a founder, solely for services, stock with more than 20 percent of the vote or more than 20 percent of a class of nonvoting stock. Unless the founder group can recognize significant losses, this is typically less desirable than the first approach because it requires gain recognition on all contributions by all founders. While it derives some support from cases such as *Granite Trust Co. v. United States*[75] in a similar context, this approach is still subject to challenge. For example, the founder that was thought to have received stock solely for services may in fact have contributed non-de-minimis property in the final analysis.[76] Also, the holding period of the start-up stock received by all founders in the exchange will be reset, which can give rise to short-term capital gain if a sale occurs within one year of the start-up's formation.

IV. Section 7874

A common fact pattern is that the idea to move offshore either does not come up or is not implemented until a U.S. start-up has already been established. Moving an existing, albeit nascent, U.S. start-up to an offshore jurisdiction for tax purposes is made difficult, if not impossible, by section 7874 — the new anti-inversion rule.

A. Issues for a Start-Up

Section 7874 treats a foreign corporation as a domestic corporation for tax purposes if:

1. the foreign corporation acquires substantially all the properties of a domestic corporation (or substantially all the properties constituting a trade or business of a domestic partnership) (the property transfer test);

2. after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which (or under the laws of which) the foreign corporation is created or organized, when compared with the

[71] However, section 367(d) could not apply unless there is a section 351 exchange. So at least one of the two transfers must be a section 351 exchange for this antiabuse rule to be operative. Unfortunately, whether both transfers must be a section 351 exchange for the antiabuse rule to apply is less certain. I believe the antiabuse rule does not apply unless both transfers are of a type that could be subject to section 367(a) (including exchanges described in section 332, 351, 354, 356, or 361). Section 367(a)(1).

[72] The sale could be made to one or more appropriate subsidiaries of the start-up parent company. For example, the U.S. rights of a patent could be sold to a U.S. subsidiary, and the non-U.S. rights could be sold to a non-U.S. subsidiary organized in a proper jurisdiction.

[73] To be attractive for venture financing, a start-up may also require an exclusive and perpetual license — frequently for all fields of use and geography — in which case a license would for tax purposes likely be treated as a sale for deferred or contingent payment. For a general discussion of a sale as opposed to a license of intellectual property, see Harsha Reddy, "Intellectual Property: Exploitation and Disposition," 558-2nd Tax Management Portfolios (2012 and Apr. 7, 2011, C&A).

[74] For a summary of the risk of recharacterization, including a description of the cases holding for and against sale treatment, see Howard J. Rothman et al., "Transfers to Controlled Corporations: Related Problems," 759-2nd Tax Management Portfolios, para. II.B.1 (2005 and Nov. 18, 2011, C&A).

[75] 238 F.2d 670 (1st Cir. 1956).

[76] For a brief overall summary, see Rothman et al., *supra* note 74, at para. II.B.3.

total business activities of the expanded affiliated group (the substantial business activity test); and

3. after the acquisition, at least 80 percent of the stock of the foreign corporation by vote or value is held by the former stockholders of the domestic corporation by reason of holding stock in the domestic corporation (or by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership) (the 80 percent ownership test).[77]

These rules were written primarily to address inversions by established companies and are often ill-suited when applied to a start-up. A few aspects of the section 7874 rules are especially relevant to an existing U.S. start-up seeking to go offshore. First, the rules apply whether the domestic entity is a corporation or a partnership, but with one potentially important distinction. For a corporation, the property transfer test focuses on whether substantially all of its properties are acquired by the foreign corporation, regardless of the scope or nature of the activities undertaken by the corporation with those properties. For a partnership, however, the property transfer test looks to whether it transfers substantially all the properties constituting a trade or business; the test does not require the partnership to transfer substantially all its properties. Therefore, the property transfer test appears to require that the partnership be conducting a trade or business when the property transfer occurs, which is sometimes ambiguous for a technology start-up.[78]

Second, Notice 2009-78, 2009-40 IRB 452, and the recently issued temporary Treasury regulations[79] practically stopped the inversion of a start-up in connection with a significant round of venture financing. Section 7874(c)(2)(B) provides that in applying the 80 percent ownership test, stock ''sold in a public offering related to the [asset] acquisition'' is not taken into account.[80] As a result, the stock would not be included in the denominator in calculating the ownership percentage. Because of the express reference to a public offering, some taxpayers believed, quite reasonably, that stock sold in a private offering would not be subject to this exclusion (to not read ''public'' out of the statute) and undertook inversions when venture financing in which stock of the offshore company that was issued to new investors was sufficient to fail the 80 percent ownership test.[81] However, under the notice and the temporary regulations, which extended the exclusion to stock issued in a private placement, venture financing — a frequent occurrence in the life of a start-up — is generally no longer an occasion for undertaking a successful inversion.[82]

Third, the substantial business activity test could be difficult to apply for a start-up. The regulations now require that each of the following three subtests be met: (1) The employees based in the foreign country must, by both head count and compensation, constitute at least 25 percent of the total of the

[77]Section 7874(b). Some start-ups may move offshore for securities law reasons, even though the offshore entity would be treated as a domestic corporation for tax purposes. Others might move offshore by initially using an offshore entity that is taxed as a partnership rather than a corporation. Each of these approaches raises additional tax concerns.

[78]The issue may be more significant than it first appears. In cases in which several founders have been working together toward a start-up for a significant time, there is sometimes a risk that the founders may have formed a partnership for U.S. tax purposes before the formal formation of any entity.

[79]T.D. 9654 (implementing Notice 2009-78 with modifications).

[80]Section 7874(c)(2)(B).

[81]Any inversion is likely to have been taxable to the shareholders. Section 7874(c)(4) also provides that the transfer of properties ''shall be disregarded if such transfers are part of a plan *a* principal purpose of which is to avoid the purposes of'' section 7874 (emphasis added). There is some uncertainty about the scope of the phrase ''a principal purpose.'' *See* Benjamin M. Willis, ''A Principal Purpose: There Can Be Only One,'' *Tax Notes*, June 10, 2013, p. 1317 (arguing that there is little, if any difference between ''*a* principal purpose'' and ''*the* principal purpose'') (emphases added).

The notice and temporary regulations expressly extending the section 7874(c)(2)(B) rule to private placements are effective prospectively for acquisitions completed on or after September 17, 2009, the date the notice was issued. Notice 2009-78, section 5; reg. section 1.7874-4T(k). Given the effective dates, and the fact that the notice and the temporary regulations are based on section 7874(c)(2)(B), despite their references to section 7874(c)(4), it seems unlikely that section 7874(c)(4) would be invoked to challenge the expatriation of a private company in connection with a substantial private placement completed before September 17, 2009. In addition, the legislative history supports such an expatriation at least before the notice and the temporary regulations. H.R. Rep. No. 108-755, at 570 (2004) (Conf. Rep.) (House version limited to public offering); *id.* at 571 (Senate version including private placement); *id.* at 574 (conference adopting House version).

[82]Under the temporary regulations, stock issued for cash is disqualified stock and is treated as stock described in section 7874(c)(2)(B). Reg. section 1.7874-4T(b).

Under a de minimis exception, which is itself subject to an antiavoidance exception (reg. section 1.7874-4T(d)(2)), the exclusion rule does not apply if both (1) the ownership percentage calculated in determining the 80 percent ownership test without regard to the exclusion rule is less than 5 percent by both vote and value; and (2) the former equity interest holders of the domestic entity subject to the section 7874 test own less than 5 percent, by both vote and value and with the application of specific attribution rules, of any member of the expanded affiliate group that includes the foreign acquiring corporation. Reg. section 1.7874-4T(d)(1). This exception is typically of no use to a start-up in a round of financing, other than potentially in the most severely dilutive scenarios.

expanded affiliated group during the one-year period before the inversion;[83] (2) the value of the assets, including only tangible personal property or real property used or held for use in the active conduct of a trade or business, located in the foreign country must be at least 25 percent of the total value of all such group assets at the time of the inversion;[84] and (3) the group income derived in the foreign country, defined to be gross income from transactions in the ordinary course of business with customers that are located in that foreign country and are unrelated persons, much be at least 25 percent of the total gross income during the one-year period before the inversion.[85] Each subtest is a source of uncertainty for a start-up, which may have rapidly changing head count and related expenses, no significant hard assets, and no revenue. In a phone conversation, an attorney at the IRS National Office readily acknowledged these difficulties in applying the regulations to a start-up, but the attorney believed that given the language of the regulations, no assurance could be given to a taxpayer that the IRS would not seek to apply these requirements literally, even to a start-up.[86]

B. Rescission

Given the stringency of these requirements and the ambiguities in applying them to a start-up, some start-ups may seek to use the rescission doctrine to in effect reincorporate a U.S. start-up to an offshore jurisdiction, if the tax year of the initial incorporation has not yet closed.[87] On one hand, the IRS has ruled that the rescission doctrine applies to undo an incorporation motivated by hindsight,[88] and there appears to be no outright prohibition against a successful rescission being followed by a do-over of the rescinded transaction.[89] On the other hand, taxpayers are understandably anxious about invoking the rescission doctrine to invert a U.S. start-up. No private letter rulings will be issued under the current no-rule policy for rescissions.[90] The antiabuse rule of section 7874(c)(4) appears to have a sweeping breadth and mandates that "the 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.[91] Finally, a rescission of a U.S. start-up followed by its reincorporation in an offshore jurisdiction could implicate the venerable liquidation-reincorporation doctrine, adding further uncertainty.[92] These uncertainties and concerns never go away for an offshore start-up that begins its life with a rescission, and there may be unexpected U.S. tax residency of other non-U.S. entities years down the road. Of course, even if a rescission is successful, the start-up's reincorporation offshore would still require careful consideration of the U.S. tax issues.

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[83]Reg. section 1.7874-3T(b)(1).

[84]Reg. section 1.7874-3T(b)(2) and -3T(d)(5).

[85]Reg. section 1.7874-3T(b)(3) and -3T(d)(7).

[86]I believe that the approach taken by the IRS in the passive foreign investment company setting is instructive. In determining whether a foreign corporation is a PFIC, the code requires an analysis of the foreign corporation's gross income. Section 1297(a)(1). In a private letter ruling, the IRS determined that a corporation that did not have gross income, because its cost of goods sold exceeded its gross receipts, would not be treated as a PFIC because it could not meet the gross income test. LTR 9447016. Similarly, a start-up that has no gross income should not be treated as failing to meet the 25 percent gross income subtest. A start-up typically has employees and assets and therefore is expected to meet the first two subtests for a successful inversion, although some sensitivity and flexibility would be welcome in applying these tests.

[87]Rev. Rul. 80-58, 1980-1 C.B. 181. For an excellent summary of the rescission doctrine and its vagaries, see David H. Schnabel, "Revisionist History: Retroactive Federal Tax Planning," 60 *Tax Law*. 685 (2006-2007).

[88]*See, e.g.*, TAM 200513027 (permitting rescission of the incorporation of a limited liability company in anticipation of an initial public offering when the offering was cancelled because of a change in market conditions).

(Footnote continued in next column.)

[89]*See, e.g.*, LTR 201008033 (permitting rescission of a related-party sale followed by a transaction, admittedly "to achieve the business benefits . . . that the [s]ale would have produced," and agreeing to treat the subsequent transaction as a tax-free reorganization, which avoids some unintended federal income tax consequences the rescinded sale would have generated). *But see* New York State Bar Association Tax Section, "Report on the Rescission Doctrine" (Aug. 11, 2010) (suggesting that often it may be inappropriate to permit do-overs of a transaction by way of rescission).

[90]Rev. Proc. 2014-3, 2014-1 IRB 111, section 3.02(8).

[91]Section 7874(c)(4) (emphasis added).

[92]For a discussion of the liquidation-reincorporation doctrine, see Bittker and Eustice, *supra* note 7, at paras. 10.08 and 12.64. For a discussion of whether a rescission might be treated as a separate transaction at least under some circumstances, see Schnabel, *supra* note 87, at 697-703. If the rescission of a prior incorporation is treated as a separate transaction and given its own tax significance, it would appear that the liquidation-reincorporation doctrine could apply to treat the subsequent incorporation offshore as part of a larger transaction subject to section 7874. While the "separate transaction" approach may not be the general approach to a rescission, the proximity to the liquidation-reincorporation doctrine here could cause some taxpayers to be concerned about whether the rescission doctrine would be as robustly applied as elsewhere. *See also* NYSBA report, *supra* note 89, at 4 ("We believe that the interests of the government would not be served by endorsing the application of the rescission doctrine to permit 'rescissions' that are part of a plan to re-execute the same or similar transaction . . . other than in cases of execution error or other mistake existing at the time of the original transaction").