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Treasury Notice on Inversions Leaves Basic Inversion Transactions Intact

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On September 22, 2014, the Treasury Department issued Notice 2014-52 (the "Notice") designed to curb inversion transactions, which are believed to be inconsistent with its purposes of Section 7874 of this Internal Revenue Code of 1986, as amended (its "Code"). The effective date of the Notice and any Treasury regulations to be promulgated pursuant to the Notice is for any inversion transactions not completed on or before September 22, 2014, the date the Notice was issued.

In a corporate inversion, a foreign parent corporation becomes the parent corporation of a multinational corporate group replacing the U.S. (domestic) corporation as the parent corporation of the group. Consequently, the offshore profits retained by foreign subsidiaries, which were formerly controlled foreign corporations ("CFCs), can be distributed to the foreign parent and future taxable income earned by foreign subsidiaries will not be subject to U.S. taxation when earned or distributed to other foreign corporations in the group. Finally, the foreign parent corporation could make loans to the former U.S. parent or other U.S. corporations within the multinational group and thereby reduce their U.S. income tax liabilities by interest deductions on those loans.

The major effect of the Notice is what it does not do. Treasury indicated it did not want to inhibit genuine cross-border mergers or foreign investments in U.S. companies. Accordingly, "vanilla" inversion transactions are not affected where the taxpayer is restructuring to avoid U.S. taxation on foreign source earnings and not attempting to access the deferred earnings and profits of its CFCs. Furthermore, the Notice does not prohibit or adversely affect the ability of the inverted U.S. parent corporation from making loans to its foreign parent and deduct the interest to reduce its U.S. taxes.

Under Section 7874 of the Code, if the shareholders of the inverted company own at least 60% (but less than 80%) of its new foreign parent, the foreign status of the new foreign parent is respected but adverse tax results may result to the corporation and its shareholders. If the former shareholders own less than 60% of the new foreign parent, no inversion is treated as having occurred and the former U.S. parent corporation will not recognize any inversion gain over the 10-year period. However, shareholders may recognize gains in both situations under Section 367 of the Code. If the former shareholders own at least 80% of the new foreign parent, the foreign parent is treated as a U.S. corporation, which would cause the inversion to fail to accomplish all of the desired tax objectives of this inversion.

Deferred Earnings and Profits of CFCs

The Notice focuses primarily on preventing the foreign parent from accessing the deferred earnings and profits of existing CFCs by proposing Treasury regulations under three different Code sections: Sections 956(e), 7701(l) and 304(b)(5)(B). The Notice also proposes Treasury regulations under Section 7874 of the Code to prevent the use of "cash box" foreign corporations or tailoring the assets of the former U.S. corporate group to allow former shareholders to own less than 80% or 60% of its new foreign parent. Finally, the Notice prevents a U.S. parent corporation from contributing a portion of its assets to a newly formed foreign subsidiary which it spins off to its shareholders.

Code Section 956(e)

The Notice addresses post inversion tax avoidance transactions by proposing to issue Treasury regulations under Section 956(e) of the Code. Generally, under Section 956, the investment by a CFC of its earnings and profits in U.S. property is taxed to its shareholders as if those earnings had been distributed to its shareholders as a taxable dividend. In some inversion transactions, taxpayers have caused CFCs to make loans to the new foreign parent corporation by "hopscotching" over the intermediate U.S. parent corporation. Since the stock or obligation of the ultimate foreign parent corporation would not be treated as United States property under the current interpretation of Section 956, the Notice proposes that Treasury regulations will provide that solely for purposes of Section 956 any obligation or stock of a foreign-related person will be treated as United States property to the extent acquired by an expatriated CFC during the 10-year applicable period. The foreign-related person is defined by reference to Section 7874(d)(3), which refers to the rules of Sections 267(b) or 707(b) and the common control rules of Section 482.

Code Section 7701(l)

The Notice invokes the regulatory authority of Section 7701(l), which permits the Treasury to prescribe regulations recharacterizing any multiple–party financing transaction as a transaction directly among two or more of such parties where it is determined that such recharacterization is appropriate to prevent avoidance of taxes under its Code. This part of the Notice is directed at transactions that "decontrol" a CFC, and consequently frees-up untaxed CFC earnings. This would occur when a foreign corporation acquires at least 50% of the voting power of the CFC which is an expatriated foreign subsidiary. This would be done directly or through a note or transfer of property. If the transaction was not recharacterized, the acquisition by a foreign corporation of the CFC stock or the dilution of its ownership of the U.S. parent would result in the CFC being "decontrolled" and therefore no longer treated as a CFC. The "decontrolled" CFC could then distribute its deferred earnings and profits to its U.S. shareholders.

Under the Notice, if an expatriated foreign subsidiary, CFC, issues specified stock to a specified related person, the specified transaction will be recharacterized. The property transferred by the related foreign corporation to the

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expatriated foreign subsidiary, a CFC, will be treated as if transferred to the U.S. parent corporation of the CFC in exchange for an instrument of the U.S. parent corporation, which then contributes the cash or property to the CFC. Any distributions by the CFC on the stock held by the foreign parent corporation will be treated as a distribution directly to the U.S. parent corporation, which is then treated as making a matching distribution to their foreign parent. The effect of the recharacterization is to continue to treat the direct U.S. parent corporation as the owner of the stock of the CFC acquired by the ultimate foreign parent.

Code Section 304(b)(5)(B)

The Notice clarifies the application of Sections 304(b)(5)(B), which excludes the earnings and profits of a CFC, the acquiring corporation, from being taken into account in a redemption in which it acquires stock of its U.S. direct parent corporation from its indirect foreign parent corporation, if more than 50% of dividends would neither be subject to tax or included in the earnings and profits of a CFC. According to the Notice, taxpayers have taken the position that the 50% test can be met if more than 50% of the earnings and profits are sourced from the U.S. direct parent corporation. Under that view, the earnings and profits of the CFC would never be subject to U.S. taxation. The Notice proposes Treasury regulations which would require that the 50% source test be applied only at the CFC level.

In addition, the Notice proposes Treasury regulations indicating that the earnings and profits of the intermediate U.S. parent corporation must be taken into account in a redemption of its stock even if Sections 304(b)(5)(B) applies to exclude the earnings and profits of the CFC as the acquiring corporation under Section 304.

This provision of the Notice applies whether or not the redemption occurs as part of an inversion transaction.

Code Section 7874

The Notice states that Treasury regulations will be promulgated under Section 7874 to prevent the use of passive assets by foreign acquiring corporations and distributions by the U.S. group of corporations to qualify under the 60% or 80% ownership test. In addition, the Section 7874 Treasury regulations will treat as inversions the spin-off by a U.S. corporation of a newly formed foreign subsidiary not consisting of substantially all of the assets of the U.S. group.

The Notice provides that the Treasury regulation under Section 7874(c)(6) will exclude a portion of the stock of a foreign corporation from the denominator of the ownership fraction in determining whether the 60% or 80% test is met to the extent 50% of the gross value of all foreign group property constitutes "foreign group nonqualified property." The 50% test is applied after the transaction and all related transactions are completed. Generally, nonqualified property includes property described in Temporary Treasury Regulations Section 1.7874-4T(i)(7) such as cash, marketable securities and obligations of members of the expanded affiliated group.

To prevent reduction in the value of the U.S. corporate group, the Treasury regulations proposed by the Notice will treat non-ordinary course distributions during a 36-month period ending on the acquisition as part of a plan of which the principal purpose is to avoid Section 7874. Accordingly, such distributions will be disregarded in computing the ownership percentage of the U.S. shareholders.

A non-ordinary distribution is the excess of all distributions during the taxable year over 110% of the average of such distributions during the 36-month period immediately preceding such a taxable year. A distribution is any distribution of cash or property, including redemption, whether or not the distribution is non-taxable, such as a distribution under Section 355 or "boot" in a reorganization.

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The Notice indicates that Treasury regulations will be issued under Section 7874(c)(2)(A) with respect to the EAG rules to prevent a U.S. parent from distributing stock of a new foreign subsidiary. Those Treasury regulations will provide that stock of a foreign acquiring corporation received by a former shareholder and, subsequently, transferred in a transaction related to the inversion will not be treated as held by the EAG. Currently, the stock of a foreign controlled corporation received by the U.S. parent and subsequently "spun-off" or transferred to the shareholders of the U.S. parent in a reorganization described in Section 368(a)(1)(D) would not be treated as held by the EAG and would be included in both the numerator and denominator of the ownership fraction. Accordingly, such stock would continue to be treated as wholly owned by U.S. shareholders and treated as a U.S. corporation.

There are two exceptions to this rule relating to "U.S. parented groups" and "foreign parented groups" in which the stock of the foreign acquiring corporation remains in the respective group.

Request for Comments

The Notice request comments on "earnings stripping" of U.S. source earnings through intercompany debt and otherwise. The Notice indicates that the Treasury is reviewing its treaty policy regarding inverted groups. The Notice states that any future guidance will be prospective only.

For More Information

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* Law360, March 2014
** The American Lawyer 2013 and 2014 reports

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