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Treasury and IRS Issue Regulations on Inversions and Earnings Stripping

On April 4, 2016, the Treasury Department and the IRS issued temporary regulations under Section 7874 on inversion transactions that added some new restrictions and implemented provisions previewed in two prior IRS notices (the "Inversion Notices").[1] The Treasury Department and the IRS also set forth new rules in proposed regulations under Section 385 that seek to reduce or eliminate earnings stripping between certain related parties. While the temporary regulations under Section 7874 focus on inversion transactions, the proposed earnings stripping regulations under Section 385 may prevent corporations (whether domestic or foreign) from leveraging between or among related parties in order to reduce their taxable income. Since the proposed earnings stripping regulations are not limited to inversion transactions, they will have a broad application for corporations or partnerships that issue debt instruments to related parties if these proposed rules are enacted as final regulations in their present form.

Temporary Regulations Regarding Inversions

A corporate inversion is a transaction in which a US-parented group changes the jurisdiction of its parent corporation to a foreign jurisdiction. In most instances, a US-parented group engages in an inversion when the US parent is acquired by a smaller foreign company. After a corporate inversion, multinational corporate groups often enter into post-acquisition restructurings to reduce their US taxable income, including using intercompany debt to enable the US group to pay deductible interest to its new foreign parent or one of its foreign affiliates.

Generally, a corporate inversion is subject to the limitations of Section 7874 when a foreign corporation acquires a US corporation (or substantially all of its assets), the shareholders of the US corporation receive 60% or more of the stock of the foreign corporation and following the acquisition the foreign corporation does not have 25% or more of its worldwide operations in its country of organization. Under Section 7874(a)(1), such an inverted US corporation cannot use pre-acquisition losses to offset certain gain and income recognized from certain restructurings and other related party transactions during an "applicable period" of 10 years following the inversion. Under Section 7874(b), if the shareholders of the US corporation receive 80% or more of the stock of the foreign corporation, the foreign corporation will be taxable as a US corporation.

The Inversion Notices previously issued by the IRS and the Treasury Department were intended to slow the pace of inversions. In the 2014 Notice, the Treasury Department stated that regulations would be issued to inhibit the tax

[1] Notice 2014-52 (the "2014 Notice") and Notice 2015-79 (the "2015 Notice").

benefits of certain post-inversion transactions, including by preventing access to deferred offshore earnings without paying US tax through the use of hopscotch loans and establishing an anti-conduit provision to prevent the use of de-controlling strategies for controlled foreign corporations ("CFCs") to access deferred earnings without paying US tax. The 2014 Notice also proposed to change the rules for determining when an inversion occurs, including expanding the scope of the Section 7874 stock ownership test to limit the benefits of skinny-down dividends by US companies and "spinversion" transactions. The 2015 Notice further limited post-inversion transactions and supplemented the 2014 Notice by previewing a new third country rule designed to limit the ability of US companies to combine with foreign companies using a new foreign parent located in a third country and denying the substantial business activities exception in cases when the new foreign parent is located in a country where it is not a tax resident. In addition, the 2015 Notice strengthened and clarified prior anti-stuffing rules where a company's principal purpose of transferring business assets to a foreign company in exchange for foreign company stock was to avoid Section 7874. The temporary regulations largely implement these changes announced in the Inversion Notices, as well as provide certain additional restrictions.

One new restriction is that the temporary regulations disregard foreign parent stock attributable to certain prior inversions of US companies. Before these temporary regulations, some foreign companies may have acquired one or more US companies with the value of the foreign company increasing to the extent the foreign company issued its stock in connection with each acquisition of a US company. As a result of these acquisitions, the foreign company in theory would be able to complete larger acquisitions of US companies to which Section 7874 would not apply because Section 7874 generally applies where shareholders of the US corporation receive 60% or more of the stock of the foreign parent company.

The existing Section 7874 regulations treat multiple acquisitions of US companies as a single acquisition generally only if such acquisitions were pursuant to the same preconceived plan. In publishing these new regulations, the Treasury Department announced that permitting a foreign company to acquire a US company and thereby increase in size in order to avoid the 60% inversion threshold under Section 7874 in a subsequent unrelated transaction was not consistent with the purposes of the rule. Thus, for the purposes of computing the ownership percentage when determining if an acquisition is treated as an inversion under current law, the temporary regulations exclude stock of the foreign company attributable to assets acquired from a US company within three years prior to the signing date of the latest acquisition.

The temporary regulations also include new additions to the skinny-down rules announced in the 2014 Notice. These skinny-down rules generally provide that shareholders of the US company will be deemed to receive additional foreign parent company stock for purposes of the Section 7874 stock ownership rules by disregarding certain non-ordinary course distributions by the US company, including large dividends, stock buy-backs and spin-offs within the 36-month period preceding the inversion. These new additions (1) require the full amount of the disregarded distribution to be converted into foreign parent company stock even where the US company shareholders receive both cash and stock consideration in the inversion, and (2) if the acquired US company was recently distributed in a Section 355 spin-off and the value of the acquired US company was greater than its distributing US parent, the acquired US company will be treated as making an extraordinary distribution of the distributing US parent company for purposes of the skinny-down rules.

In general, the rules in the temporary regulations previewed in the 2014 Notice and the 2015 Notice are effective for transactions completed on or after September 22, 2014 and November 19, 2015, respectively. The new rules included in the regulations that disregard foreign parent stock attributable to prior acquisitions of US companies generally apply to acquisitions completed on or after April 4, 2016.

Proposed Regulations Regarding Earnings Stripping

The proposed regulations prohibiting earnings stripping through intercompany debt would limit the tax benefit attributable to deducting interest expense on certain debt held by a related party in cross border situations and where the related parties are both US companies that are not part of the same US consolidated tax group. Broadly speaking, related parties for these purposes are corporations (and controlled partnerships) where at least 80% (or 50% or more in certain circumstances) of the vote or value of their outstanding stock (or capital or profits) is owned, directly or indirectly, by the same corporate shareholder.

Under current law, in connection with or following an inversion or foreign takeover, a US subsidiary can issue its own debt to its foreign parent as a dividend distribution (or to purchase foreign parent stock to use in acquisitions) and the foreign parent may subsequently transfer such debt to a foreign affiliate in a low-taxing jurisdiction. The use of a note in these situations enables the US subsidiary to deduct future interest expense on such debt on its US income tax return subject to applicable limitations. According to the Treasury Department, these tax savings through intercompany interest expense incentivize foreign-parented firms to burden their US subsidiaries with large amounts of related-party debt.

The proposed earnings stripping regulations are issued under Section 385, which is a statute enacted in 1969 that authorizes the Treasury Department and the IRS to issue regulations to determine if corporate financial instruments are properly characterized as stock or debt (in whole or in part) for tax purposes and to establish factors to indicate for a particular situation whether there exists a debtor-creditor relationship or a corporate-shareholder relationship. In proposing these regulations, the Treasury Department and the IRS identified three types of transactions as raising significant policy concerns under Section 385: (1) distributions of debt instruments by corporations to their related corporate shareholders; (2) issuances of debt instruments by corporations to related parties in exchange for stock of an affiliate; and (3) certain issuances of debt instruments as consideration in an exchange involving an intragroup asset reorganization. In addition to these transactions, the proposed regulations set forth a funding rule that, broadly speaking, treats as equity certain related party debt issued with a principal purpose of funding a distribution or acquisition identified in these three types of transactions. There is also an anti-abuse rule that treats as equity debt instruments or other interests (e.g., contracts to which Section 483 applies or nonperiodic swap payments) issued with a principal purpose of avoiding the proposed regulations. Under this anti-abuse rule, a debt instrument may be treated as equity when the instrument is issued to, and later acquired from, an unrelated party.

These identified transactions, according to the Treasury Department and the IRS, are instances where equity is replaced with debt with little or no non-tax effect. Two examples of concern cited were foreign-parent groups generally and inverted groups in particular using these transactions to generate interest deductions that reduce US taxable income without investing new funds into the US. Moreover, US-parented groups can use these transactions in repatriation planning for untaxed earnings and profits of CFCs. To illustrate, a CFC that is a first-tier subsidiary of a US parent corporation can distribute a note to its US parent in a year when the CFC has no earnings or profits (accumulated or current) but when the US parent has significant tax basis in the CFC stock. Thereafter in a year

when the CFC has earnings, the CFC can pay off the note and thereby repatriate profits to the US parent without US tax. For these reasons, the regulations propose to treat debt instruments issued and held by related parties in these transactions as equity subject to certain exceptions.

The proposed regulations generally do not apply to related-party debt that is incurred for new cash to fund actual business investment, such as building or equipping a factory (or to make distributions or fund acquisitions limited to current earnings and profits). Furthermore, the proposed regulations only apply to debt issued between related corporations (generally based on 80% direct or indirect stock ownership), subject to a general anti-abuse rule for structured transactions involving unrelated persons, that are members of groups that have more than $50 million of intercompany debt that otherwise would be treated as equity under the regulations.

The proposed regulations under Section 385 have application that is far greater than the existing earnings stripping rules under Section 163(j) originally enacted in 1989. The 1989 rules, when applicable, generally allow a US subsidiary to deduct up to 50% of its net cash flow in a particular year paid as interest expense on debt owed to its foreign parent.

Subject to certain transition provisions, the proposed regulations prohibiting earnings stripping through these identified transactions involving intercompany debt would apply to any debt instrument issued on or after April 4, 2016. For debt instruments issued before the rules are finalized (but on or after April 4, 2016) these proposed rules would treat that debt as equity only after the 90-day period following the adoption of final regulations.

The IRS May Divide a Debt Instrument into Part Debt and Part Equity

Under current law, instruments are generally treated as either debt or equity for federal tax purposes. This all-or-nothing approach creates uncertainty in the view of the Treasury Department and the IRS when the facts and circumstances support (because of its terms or other features) treating an instrument as part debt and part equity. The proposed regulations would allow the IRS to treat an instrument issued to a related party (generally based on 50% direct or indirect stock ownership) as in part debt and in part equity and generally would apply to debt instruments issued or deemed issued on or after the regulations are published in final form.

Requiring Documentation for Members of Large Groups to Include Key Information for Debt-Equity Analysis

Under the proposed regulations, companies are required to undertake certain due diligence and complete documentation with prescribed time limits in order to establish that a financial instrument issued to a related party qualifies as debt for tax purposes. Specifically, the proposed regulations require key information be documented, including a binding obligation for the issuer to repay the principal amount borrowed, creditor's rights, a reasonable expectation of repayment and evidence of an ongoing debtor-creditor relationship. If these requirements are not met, instruments will be characterized as equity for tax purposes. However, satisfaction of these requirements will not establish that a related party instrument will be treated as debt for tax purposes. The proposed regulations requiring this documentation would apply to any instrument issued or deemed issued on or after the date the regulations are published in final form.

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Inversion transactions, earnings stripping and debt/equity characterizations are areas that will continue to evolve, particularly in light of the new rules announced by the Treasury Department and the IRS in the temporary and

proposed regulations, and you are urged to stay informed as matters develop. If you have any questions regarding inversion transactions, earnings stripping or related tax matters, please do not hesitate to contact any of us.

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