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Client Alert
Commentary

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Treasury Announces Inversion Regulations; Reach Extends to Other Cross-Border M&A

New guidance seeks to curb the incidence of inversions and reduce the associated tax benefits, but also extends beyond inversions.

On September 22, 2014, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued Notice 2014-52 (the Notice) announcing their intent to provide regulations addressing the recent wave of certain cross-border M&A transactions commonly referred to as inversions.

Under existing anti-inversion provisions, a foreign corporation acquiring a US corporation is treated as a US corporation for US tax purposes if, among other requirements, the amount of stock (by vote or value) of the foreign acquiring corporation owned by former shareholders of the acquired US corporation following the acquisition by reason of ownership of the acquired US corporation (the inversion fraction) is at least 80 percent. If the former shareholders of the acquired US corporation own less than 80 percent but at least 60 percent of the shares, then certain limitations apply to the entire corporate group on the use of tax attributes, and an excise tax may apply to certain executive compensation.

The Notice describes future regulations that can be separated into two categories: (i) special rules for determining whether the inversion fraction crosses the 60 percent or 80 percent ownership threshold and (ii) rules targeting certain tax planning after an inversion, primarily to access foreign earnings of the US acquired corporation. Treasury stated that often, the US corporation involved in an inversion transaction owns controlled foreign corporation subsidiaries (CFCs) which have accumulated foreign earnings in low-taxed jurisdictions. According to Treasury, various techniques are often utilized to access those earnings without triggering a repatriation tax.

Part I, below, discusses the first category of regulations, which generally will provide that in determining whether the inversion fraction has been met:

- Stock of an acquiring foreign corporation is not counted to the extent it is attributable to passive assets (in cases where the foreign corporation has a high percentage of such passive assets)
- Certain distributions by the acquired US corporation are ignored
- In the case of a distribution of a foreign corporation in a spin-off, certain special rules apply depending on whether the distribution is by a US parent or a foreign parent

Part II discusses the second category, which includes regulations that would:

- Treat certain “hopscotch” loans made by foreign subsidiaries as US property (thereby subject to the CFC rules)

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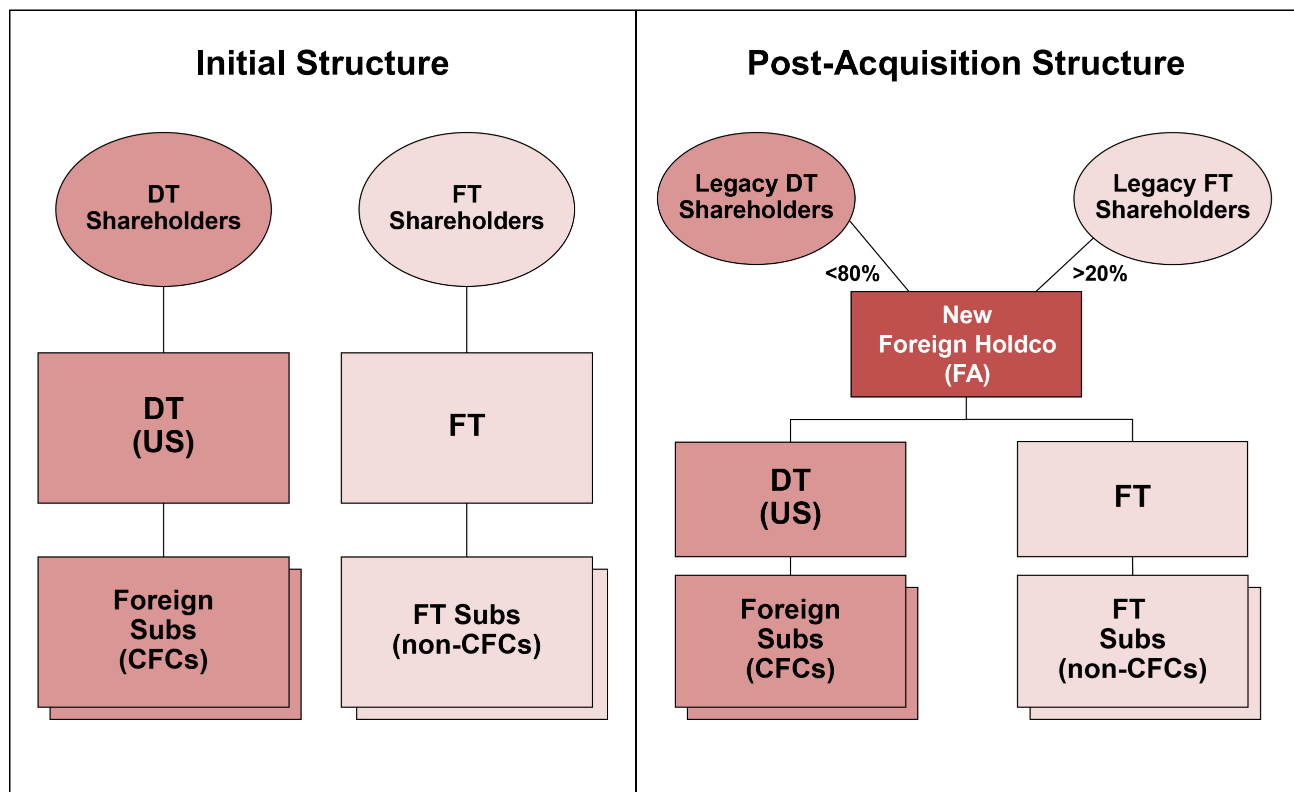
- Limit transactions that seek to decontrol CFCs for purposes of avoiding US tax
- Modify the rules for certain cross chain Section 304[1] transactions to require a dividend withholding tax

Importantly, while the first two rules discussed in Part II apply only to transactions following an inversion, where former shareholders of the acquired US corporation own at least 60 percent but less than 80 percent of the shares of the foreign acquiring corporation, the third rule would apply without regard to an inversion, including situations where a foreign parented group acquires a US target for cash or otherwise in a non-inversion transaction, or even situations involving legacy foreign parent structures.

While the regulations discussed in the Notice will certainly affect companies considering an inversion transaction, their reach extends to general mergers and acquisitions due to the heightened risk of an accidental inversion. Multinational corporations seeking to acquire foreign targets for cash or stock, in transactions assumed to be well outside the scope of the inversion rules, will need to consider whether such "foreign" targets have previously engaged in transactions that triggered the inversion rules. In that case, the foreign target company might actually be treated as a US company, or, even if treated as a foreign company, might "taint" the entire expanded affiliated group (EAG) of the acquirer for purposes of applying restrictions on tax attributes or access to CFC cash pools. In other words, if a so-called "surrogate foreign corporation" joins a multinational group, the entire group would be subjected to certain aspects of the inversion rules.

The regulations discussed in the Notice will apply to any acquisition completed on or after September 22, 2014. Thus, this guidance picks up transactions that have been announced but that have not yet closed.

For purposes of the following discussion, assume that a US corporation (DT) and a foreign corporation (FT) seek to combine under a new foreign holding corporation (FA). The first chart below depicts the structure immediately before the transaction, and the second depicts the structure after the transaction.



I. Regulations to be Issued Addressing Inversion Fraction

Each of these regulations to be issued, discussed below, puts pressure on the ability of shareholders of acquired US corporations to stay below the 60 percent and 80 percent ownership thresholds.

- **Limitation on passive assets:** FA may attempt to inflate its size (and thereby favorably reduce the inversion fraction) by retaining or accumulating passive assets such as cash, cash equivalents and marketable securities. Where at least 50 percent of FA's assets are passive, the Notice provides for regulations excluding from the denominator of the inversion fraction the portion of FA's stock attributable to passive assets that are not part of the corporation's daily business functions. Banks and financial services companies are exempt from this regulation.

  - Existing regulations modified the inversion fraction on account of FA stock issued for certain passive assets in a related transaction (*i.e.*, stuffing transactions). By contrast, under the Notice, if the requisite 50 percent threshold is met, then the inversion fraction will be modified on account of passive assets, even if such assets were acquired in an unrelated transaction, such as a strategic asset sale for cash.

  - The passive asset determinations are made on a group basis (employing EAG principles). Certain obligations between EAG group members are disregarded to avoid double counting, and certain property held by DT at the time of the acquisition is disregarded.

- **Limitation on extraordinary dividends:** To reduce its size in advance of an inversion transaction (and thereby favorably reduce its inversion fraction), DT might make an extraordinary dividend, often referred to as a "diet" or "skinny-down" dividend. New regulations will disregard any non-ordinary course distributions by DT during the 36-month period before the inversion transaction. Non-ordinary course distributions equal the excess of (i) all distributions made during the taxable year by DT over (ii) 110 percent of the average of all distributions during the 36-month period immediately preceding such taxable year. Distributions include not only dividends and distributions made in redemption of stock, but also the transfer of money or other property to shareholders in connection with the inversion transaction (to the extent that such money or other property is directly or indirectly provided by DT).

  - Under existing law, a diet dividend is disregarded if a principal purpose of such dividend is to avoid the application of the inversion rules. By contrast, under the Notice, non-ordinary course distributions will now be disregarded regardless of their purpose. Thus, for example, a spin-off in the three years preceding the inversion transaction might be disregarded under this provision.

  - Note that diet dividends have also been used to shrink DT's value for purposes of enabling FA's acquisition of DT to qualify as a tax-free transaction for the DT shareholders under the "Helen of Troy" regulations under Section 367. (The "substantiality" test portion of those regulations requires that the fair market value of DT be no greater than the fair market value of FT.) Significantly, the Notice states that non-ordinary course distributions will now be disregarded for this purpose as well.

- **Limitation on "spinversions":** A publicly traded US parent may transfer assets (such as, for example, stock of a US subsidiary) to a newly formed foreign subsidiary corporation (Foreign Spinco) and then subsequently distribute the Foreign Spinco stock to its shareholders. Note that absent application of the EAG rules, the Foreign Spinco stock received by the US parent would be included in the numerator of the inversion fraction (generally resulting in 100 percent US ownership). However, if the EAG rules apply, then the Foreign Spinco stock would be excluded from the numerator of the

inversion fraction (resulting in zero percent US ownership). Thus, this transaction raises the question of whether the subsequent distribution of Foreign Spinco by the US parent (which results in Foreign Spinco being outside of the EAG) should be taken into account in determining whether the EAG rules apply. The Notice answers in the affirmative as it provides that if the stock of Foreign Spinco is subsequently transferred in a transaction related to the acquisition, then subject to certain exceptions, the Foreign Spinco stock will not be treated as being held by a member of the EAG, and hence such stock will be counted in both the numerator and the denominator for purposes of calculating the inversion fraction.

- Note that although the Notice focuses on spin-offs, the scope of the rule is not limited to spin-offs, as it takes into account any subsequent transfers of Foreign Spinco stock related to the acquisition.

II. Regulations to be Issued Targeting Post-Closing Intercompany Financing and other Transactions

According to Treasury, the Notice also seeks to reduce the tax benefits available to entities that successfully invert. CFCs may have earnings and profits that have not yet been repatriated (deferred earnings). The regulations to be issued, summarized below, will eliminate methods of accessing the CFC's deferred earnings without paying US tax.

- **Limitation on "hopscotch" loans:** If DT received a dividend from a CFC subsidiary, such amount would be taxable income to DT. Section 956 provides the same result if CFC loans its deferred earnings to DT, or otherwise invests in US property. However, before the Notice, DT could avoid US tax on CFC's deferred earnings, if such earnings instead were loaned to FA, FT or to other non-CFCs following the inversion transaction. The Notice provides regulations treating loans that "hopscotch" over DT as CFC investments in US property subject to US tax for the 10-year period following the inversion. The rule will also apply to CFCs' acquisitions of stock of FA, FT or non-CFCs.

  - The provision targets not only intercompany loans, but can also affect commercial loans to FA, FT or non-CFCs for which CFCs provide credit support. If the CFC guarantees or pledges its assets in support of a loan of FA, FT or non-CFCs, then the CFC is treated as making the actual loan to the related foreign party, deemed under the Notice to be a potentially taxable investment in US property.

  - Pledges of more than 66 2/3 percent of the voting stock of the CFC in favor of a lender to FA, FT or the non-CFCs will also be a deemed investment in US property that can give rise to a Section 956 inclusion at DT.

- **Limitation on "de-controlling" a CFC:** Following an inversion, the new foreign parent FA may issue a note or transfer property to a CFC in exchange for enough stock to possess control of the CFC, thus causing the entity to cease being a CFC (because the DT group owns less than 50 percent of the vote and value of the CFC taking into account the existing attribution rules). According to Treasury, this de-controlling transaction may allow access to the CFC's earnings without subjecting them to US taxation, such as by permitting loans from the former CFC to the DT group or by allowing FA to extract the accumulated earnings of the former CFC through dividend equivalent redemptions. The new regulations will curb this practice by treating the new foreign parent as owning stock in the former US parent, rather than in the CFC. As a result, the deferred earnings of the CFC will remain subject to US tax. These rules would apply generally to de-controlling transactions completed in the 10-year period following an inversion. Interestingly, the IRS uses a combination of Section 367(b)

authority and the rules targeting certain “conduit financing arrangements” in order to target these structures.

- **Limitation on avoidance of tax by exchanging stock for cash or property of CFC:** Following an inversion, a new foreign parent might engage in certain Section 304 transactions designed, according to Treasury, to extract the accumulated earnings of a CFC without incurring US tax. For example, FA might sell stock in DT to a CFC in exchange for cash or property of the CFC. In many cases, this transaction would not result in income or gain giving rise to an income inclusion, thus allowing for the tax-free extraction of the CFC’s cash and property. The Notice provides for regulations eliminating this method by adjusting the Section 304 rules regarding the inclusion of dividends in the earnings and profits of CFCs. Importantly, unlike the rules described above, these rules will apply generally without regard to whether an inversion transaction has occurred. That is, these rules will apply in situations involving existing foreign parented group/US subsidiary structures, including those that are “old and cold.”

III. Future Guidance

Notably, the Notice does not provide regulations limiting the use of intercompany debt. Commentators have recently suggested placing limitations on excessive related-party debt, which, according to Treasury, US corporations have used to reduce US-source earnings. While the Notice does not include such limitations, it does state that Treasury and the IRS are considering guidance on this point. Treasury is also reviewing its tax treaty policy with respect to inverted groups.

Importantly, although any future guidance may apply prospectively, the Notice states that “to the extent any tax avoidance guidance applies only to inverted groups, such guidance will apply to groups that completed inversion transactions on or after September 22, 2014.”

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Endnotes

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.