Client Alert

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Latest Treasury Action on Inversions Upends Pending Transactions and Surprises Many for Its Broad Scope and Use of Questionable Authority

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On April 4, 2016, the Treasury Department and the Internal Revenue Service issued a sweeping package of new regulations intended to curtail inversion transactions (the "Regulations"). Many features of the Regulations had been previewed by prior IRS guidance and therefore were anticipated.[1] However, the Regulations also introduced new and largely unexpected anti-inversion rules addressing so-called "serial inversions" and other multi-step inversions, as described below.

At least as surprising and of much broader relevance, the Regulations also take direct aim at "earnings stripping" transactions whereby intragroup financing is used to reduce U.S. taxable income. Although Treasury was known to be considering earnings stripping guidance, it was widely expected that either such guidance would not be issued at all, given a potential lack of Treasury authority, or the guidance would be limited to taxpayers that had previously expatriated. Importantly, the proposed earnings stripping rules that were issued are not limited to the inversion context and instead are of potential relevance in a wide range of commercial situations, including for any multinational group that utilizes internal financing.

Given their scope and the timing of their release, many believe the new regulations were directly aimed at thwarting Pfizer's proposed acquisition of Allergan, a $160 billion inversion that was scheduled to close in mid-2016. Treasury has denied targeting any particular transaction, but the Regulations nevertheless hit the mark: Less than two days after the Regulations were issued, the Pfizer/Allergan transaction joined the Pfizer/AstraZeneca transaction and many others that have collapsed in the wake of Treasury action during the past two years.

After a brief refresher on inversion transactions, this Client Alert will explain the key features of the Regulations and offer thoughts on the resulting landscape for cross-border business combinations. In light of their technical detail and far-reaching implications, the earnings stripping proposals are touched on below but are also separately discussed in greater detail in our Client Alert, *Proposed IRS Debt-Equity Regulations: Aimed at Post-Inversion "Earnings Stripping," But May Also Impact Ordinary Related-Party Debt*.

[1] See Notice 2014-52 and Notice 2015-79, collectively referred to in this Client Alert as the "**Notices**."

INVERSIONS GENERALLY

Generally, an inversion is a transaction in which a U.S. corporation is redomiciled into a foreign jurisdiction or becomes the subsidiary of a foreign parent. Typically, inversions are carried out by the U.S. parent of a multinational group of corporations, so that the group can become controlled by a foreign parent rather than a U.S. parent. Historically, this has positioned the group to reduce U.S. taxes following the transaction by putting future growth outside of the United States, engaging in certain intragroup restructurings, and other measures described in our July 2014 Client Alert, *The Inversion Craze: Will Today's Routine Tax Planning Be Retroactively Outlawed?*

Historically, there were a greater number of ways to achieve an inversion, but in more recent years there has been only one viable option: to merge with a non-U.S. company in a transaction in which the shareholders of the foreign merger partner receive more than 20% of the shares in the combined foreign entity. Failure to exceed this 20% threshold will result in the combined corporation being treated as a U.S. corporation for U.S. tax purposes, despite being organized under foreign corporate law.[2] For this reason, virtually all inversion transactions satisfy this greater-than-20% share ownership test.

The existing anti-inversion rules impose a less severe penalty in the case of an inversion transaction in which the shareholders of the foreign merger partner receive more than 20%, but not more than 40%, of the shares in the combined foreign entity. In that case, the U.S. company is subject to a special "toll charge" with respect to certain income generated during a 10-year period after the transaction. In this Client Alert, we use the term "60% Inversion" to refer to a transaction that falls into this category, that is, where the U.S. corporation's shareholders own at least 60%, but not 80% or more, of the combined entity following the transaction. Many of the new limits on post-inversion restructurings apply only to these 60% Inversions.

The 60% and 80% ownership thresholds discussed above are collectively referred to in this Client Alert as the "Ownership Threshold."

THE REGULATIONS

The Regulations significantly expand the reach of the anti-inversion regime by disregarding certain transactions that have occurred prior to the current merger and by adopting other special rules that make it more likely that the Ownership Threshold will be met in a given transaction. The Regulations also restrict the ability to engage in certain common post-inversion tax strategies.

[2] An exception to the application of the punitive anti-inversion rules exists if the inverted group satisfies a "substantial business activities" test – *i.e.* if the business activities conducted by the group in the foreign parent's country of incorporation are "substantial" when compared to the group's worldwide business activities. Due to the stringent requirements of the "substantial" standard, this exception is little relied upon in practice, and the Regulations further restrict its availability by requiring that the foreign parent be a tax resident in its country of incorporation.

Extending the Reach of the Anti-Inversion Rules

Integrating Multi-Step Transactions

The Regulations introduced a new rule, not previewed in the Notices, that integrates certain multi-step transactions conducted pursuant to a plan. This rule is designed to prohibit taxpayers from avoiding the anti-inversion rules through back-to-back foreign acquisitions.

According to Treasury, certain taxpayers have relied on existing law to claim that an intermediary foreign corporation may acquire a U.S. corporation in a transaction that does not run afoul of the anti-inversion rules and then, pursuant to the same plan, have the intended ultimate foreign acquiror acquire the foreign intermediary. This back-to-back acquisition approach is apparently hoped to allow taxpayers to avoid the anti-inversion rules in cases where a direct acquisition of the U.S. company by the ultimate foreign acquiror would have violated those rules. For example, the intermediary foreign corporation might be incorporated in a jurisdiction in which the group has adequate business activity to qualify for the “substantial business activities” exception to the anti-inversion rules, whereas the ultimate foreign acquiror might be incorporated in a jurisdiction, such as the Cayman Islands, where the group has no meaningful business activities. If the two steps were respected as separate, the first step acquisition would qualify for the exception, and the second step was hoped to simply lie outside the rules on the basis that it is an acquisition of one foreign corporation by another.

Under the Regulations, the back-to-back acquisitions will effectively be collapsed for purposes of the inversion rules, and the entire transaction will be analyzed as a direct acquisition of the U.S. company by the ultimate foreign acquiror. This rule applies to transactions completed on or after April 4, 2016.

Tightening the Ownership Threshold

The Regulations feature several rules that will cause the Ownership Threshold to be met in far more potential transactions. Despite their putative status as “anti-abuse rules,” the Regulations as drafted can cause transactions having no substantive relationship to the inversion itself to be taken into account in determining whether the Ownership Threshold is met. The changes therefore will significantly increase the due diligence required in virtually all cross-border mergers and acquisitions.

Disregard Serial U.S. Acquisitions

The Regulations introduce a new rule, which had not been suggested by the Notices or otherwise prior to April 4, that disregards for purposes of computing the Ownership Threshold stock of the foreign merger partner that was issued in connection with recent prior acquisitions of U.S. entities. Specifically, this “serial acquisition” rule disregards stock of the foreign merger partner that was issued in connection with any acquisition of U.S. entities in the 36-month period before the signing date of the present inversion, after adjusting for redemptions and capital structure changes that occurred after the earlier acquisitions. Certain *de minimis* exceptions exist for prior acquisitions that do not involve a significant amount of foreign issuer shares.

Notably, the serial acquisition rule applies to all acquisitions of U.S. entities within the lookback period, even if the acquired U.S. entities are operating businesses, and without regard to whether the acquisitions were made with any intent to avoid the anti-inversion rules or were otherwise pursuant to a plan that includes the inversion. As a result, the rule could implicate a significant number of contemplated expatriation transactions, no matter how innocuous the prior acquisitions seemed at the time. This rule applies to inversions completed on or after April 4, 2016.

The serial acquisition rule was of direct and fatal relevance to the proposed Pfizer/Allergan transaction, as Allergan had previously been party to three different inversion transactions within the past three years.

Prohibit "Third Country" Inversions

In recent years, many inversions took the form of so-called "double dummy" transactions, in which a new foreign holding company acquired both the U.S. company and its foreign merger partner. This structure allowed the parties to establish the group's new foreign parent in their (invariably low-tax) jurisdiction of choice, without being bound by the home jurisdiction of the existing foreign corporation. This "third country" structure was used to combine Endo Health Solutions Inc. (*U.S.*) and Paladin Labs Inc. (*Canada*) under a newly formed Irish holding company in 2014.

As previewed by the Notices, the Regulations largely eliminate the ability to use a third country holding company as the acquiror in any inversion in which shareholders of the U.S. company own at least 60% of the combined group following the transaction. Specifically, under the Regulations all shares of the foreign holding company that are issued to former shareholders of the foreign merger partner will be disregarded for purposes of the Ownership Threshold if: (i) the foreign holding company and foreign merger partner are tax residents of different jurisdictions; (ii) former shareholders of the foreign merger partner receive at least 60% of the foreign holding company shares when the foreign holding company acquires the foreign merger partner (this would generally be the case if the foreign holding company is a newly formed corporation, as is typical in a "double dummy" transaction); and (iii) the Ownership Threshold (determined without regard to this "third country" rule) is at least 60%.

If the above third country rule applies to a transaction, the practical effect is almost always to treat the foreign holding company as a U.S. corporation for U.S. tax purposes, since the Ownership Threshold is usually least 80% on the typical facts of third country structures. This rule generally applies to inversions completed on or after November 19, 2015 (the date on which this rule was first described in Notice 2015-79).

Disregard Certain Extraordinary Distributions

Consistent with the Notices, the Regulations disregard the effects of extraordinary distributions made by the U.S. company within the 36-month period before the inversion, subject to certain *de minimis* exceptions (the "Anti-Slimming Rule"). Generally, extraordinary distributions are those distributions during a 12-month period that exceed 110% of the average distributions made by the U.S. entity during the 36-month period immediately preceding such 12-month period. Although perhaps conceived of as an anti-abuse rule, the Anti-Slimming Rule adds back to the value of the U.S. entity any extraordinary distributions made during the 36-month window, whether or not the distribution was intended to evade the inversion rules.

Notably, stock redemptions and otherwise tax-free distributions have the potential to be treated as extraordinary distributions for this purpose. Commentators on the Notices called for an exception for tax-free spin-off distributions, presumably on the basis that the stringent business purpose requirement imposed upon spin-offs makes them especially unlikely to present abuse. Treasury rejected this proposal, and instead actually expanded the Anti-Slimming Rule as applied to tax-free spin-offs. Specifically, under the new spin-off rule, if a tax-free distribution of a domestic corporation ("Controlled") by another domestic corporation ("Distributing") precedes an acquisition of Controlled and the value of Controlled represents more than 50% of the value of Distributing immediately before the distribution, *Controlled* is deemed to have made an extraordinary distribution of *Distributing* for purposes of applying the Anti-Slimming Rule to a subsequent acquisition involving Controlled. As a result, the Ownership Threshold will be applied after increasing the value of Controlled by the value of Distributing, making it more likely that anti-inversion rules will apply to the acquisition of Controlled. This rule generally applies to inversions completed on or after September 22, 2014.

The pending inversion transaction between Shire PLC and Baxalta Inc. is believed to have implicated the new spin-off rule, in light of Baxalta's recent spin-off from Baxter International Inc and the relative values of the two companies at the time of the spin-off. Notwithstanding these changes, Shire has publicly stated that it does not expect the Regulations to prevent its combination with Baxalta from proceeding.

Disregard Passive Assets of Foreign Acquiror

The Regulations also disregard shares of the foreign merger partner that correspond to certain "nonqualified properties" held by the foreign entity and its affiliates (the "Foreign Acquiror Group"), where the total nonqualified properties held by the Foreign Acquiror Group exceed 50% of the gross value of the Foreign Acquiror Group's assets. These rules were first announced in the Notices. "Nonqualified properties" include liquid assets such as cash and marketable securities, and any other properties transferred with a principal purpose of avoiding the anti-inversion rules.

Disregard Temporary Ownership of Foreign Acquiror Stock by Group Members

In determining whether the Ownership Threshold is met, the current rules afford special treatment for shares of the foreign merger partner that are issued to members of the same corporate group, so that a transaction is less likely to meet the Ownership Threshold and be treated as an inversion. In line with the Notices, the Regulations generally eliminate this preferential treatment if the shares of the foreign merger partner are subsequently transferred outside of the corporate group in a transaction related to the inversion. This rule is apparently aimed at preventing certain "spinversions" (in which a U.S. company transfers a business in exchange for shares of a newly-formed foreign subsidiary and then distributes shares of the foreign subsidiary to its shareholders) and other transactions featuring mere transitory ownership by a corporate shareholder. This rule generally applies to inversions completed on or after September 22, 2014.

Eliminating Certain Post-Inversion Tax Saving Strategies

The Regulations severely limit techniques that have been commonly employed by foreign-parented groups to generate U.S. tax savings following an inversion, including limits on the inverted group's ability to access the overseas earnings of the expatriated U.S. group without triggering current U.S. tax on those earnings, and limits on earnings stripping transactions. Except with respect to the earnings stripping rules and the related party sale rule, the following provisions apply only to corporate groups that have undertaken a 60% Inversion.

Restrictions on Earnings Stripping Techniques

What is probably the most unexpected and controversial aspect of the Regulations is a new set of rules intended to curtail “earnings stripping” techniques that are generally believed to be a key component of the tax savings in many inversion transactions (the “Earnings Stripping Rules”). Although the Earnings Stripping Rules will be of tremendous importance in the inversion context, they are explicitly not limited to that context. For more detailed coverage of the Earnings Stripping Rules and their potential to reach a broad range of commercial transactions, please see our separate Client Alert.

Unlike most other provisions of the Regulations, the Earnings Stripping Rules are only issued in proposed form, and they are subject to comments and public hearing. It also is important to note that in light of the Supreme Court decision in *United States v. Home Concrete Supply, LLC*, 132 S. Ct. 1836 (2012), as well as the Tax Court decision in *Altera Corp. v. Commissioner,* 145 T.C. No. 3 (2015), it is clear that the Treasury Department must follow all requirements of the Administrative Procedures Act and take taxpayer comments into account in finalizing any regulations. For prior coverage on these subjects, please see our prior Client Alerts discussing the decisions in *Home Concrete & Supply, LLC* and *Altera.* The notice and comment period with respect to the Earnings Stripping Rules is open through July 7, 2016, and when finalized the rules generally would apply to debt instruments issued on or after April 4, 2016, subject to certain grandfathering rules.

Generally, the Earnings Stripping Rules operate by treating purported debt issued by a corporation to a member of its “Expanded Group” as equity if the debt is issued (1) in a distribution, (2) in exchange for Expanded Group stock, or (3) in exchange for properties in an intra-group asset reorganization, in each case subject to certain exceptions. Similarly, the Earnings Stripping Rules would treat as equity purported debt issued by a corporation to its Expanded Group in exchange for properties, if a principal purpose of the issuance is to allow the debt issuer to fund any of the three categories of transactions described in the preceding sentence. Anti-avoidance rules apply to police these standards. For this purpose, an “Expanded Group” generally includes a group of U.S. and foreign entities connected to each other by ownership of at least 80%.

The Earnings Stripping Rules also impose rigid documentation requirements for a related party indebtedness to be respected as debt for U.S. tax purposes. These include documentation that substantiates a binding obligation for the debtor to repay the amounts borrowed, the creditor’s rights to enforce the terms of the loan, a reasonable expectation that the borrowed funds could be repaid, and evidence of an ongoing debtor-creditor relationship. Generally, these documents must be executed contemporaneously with the borrowing.

Earnings stripping of the sort targeted by the Regulations has long been a standard part of the toolkit for post-inversion planning, as well as for multinational groups more generally. While some earnings stripping strategies remain (as discussed below), the Regulations, if adopted, will dramatically alter the tax-planning landscape for many multinational groups.

Prohibition of "Hopscotch" Loan or Equity Investment

Foreign subsidiaries that are majority owned by the former U.S. parent generally constitute "controlled foreign corporations" ("CFCs") for U.S. tax purposes. Generally, the former U.S. parent can defer U.S. tax on the earnings of its CFCs only until those earnings are brought back to the United States in the form of a dividend, a loan to the U.S. parent, or some other investment in "United States property" (as specially defined for this purpose). Previously, a so-called "hopscotch" loan to, or an equity investment in, the inverted group's new foreign parent or another non-CFC foreign affiliate was not treated as an investment in "United States property" for this purpose (since it technically was not a loan to or an investment made in any U.S. person) and therefore such a transaction would not trigger U.S. tax.

As previewed in the Notice, the Regulations alter this treatment with respect to corporate groups that undertake a 60% Inversion on or after September 22, 2014. For those groups, loans by a CFC group member to (or equity investments made by the CFC in) the foreign parent or another non-CFC foreign affiliate (i) during the 10-year post-inversion period or (ii) in a transaction related to the inversion generally would be treated as investments in "United States property," thus triggering current U.S. taxation to the former U.S. parent. Similar treatment applies if a CFC provides a pledge or guarantee with respect to an obligation of such a foreign affiliate.

Prevent Tax-Free Dilution of Existing CFCs

The Regulations also contain rules that prevent the tax-free dilution of existing CFCs of the former U.S. parent. Previously, following an inversion the new foreign parent or another foreign affiliate could purchase newly issued shares in an existing CFC of the former U.S. parent representing at least 50% of such foreign subsidiary, as a result of which the foreign subsidiary would cease to be a CFC. The group would then have greater flexibility to access the foreign subsidiary's pre-inversion earnings without triggering current U.S. tax. Even if the foreign parent acquired a smaller stake, so that the foreign subsidiary remained a CFC, the CFC's pre-inversion earnings might later be used to redeem the shares now owned by the foreign parent, thereby reducing the pool of earnings that would potentially be taxed to the former U.S. parent when eventually repatriated to the United States. Such a dilutive transfer could take the form of a new share issuance by the CFC or a transfer of shares by the U.S. company.

Consistent with the Notice, the Regulations would undermine the effectiveness of these dilutive transactions undertaken during the 10-year post-inversion period by corporate groups that undertake a 60% Inversion on or after September 22, 2014. Although the details depend on the particular type of transaction involved, the Regulations generally accomplish this by recharacterizing these transactions in a manner that ensures the appropriate U.S. tax would be paid.

Prevent Tax-Free Repatriation of Foreign Earnings through Related Party Stock Sales

Consistent with the Notices, the Regulations prohibit the tax-free repatriation of a CFC's pre-inversion earnings. Previously, one method for accomplishing this was having the CFC purchase shares in the former U.S. parent from the new foreign parent. Such a share purchase is generally recharacterized as a deemed dividend to the foreign parent to the extent of the earnings of the CFC and of the U.S. company. At least some taxpayers had taken the position that this deemed dividend to the foreign parent would deplete the CFC's earnings without any tax to the U.S. company under the CFC rules.

The Regulations modify the existing rules to clarify that this deemed dividend would only reduce the earnings of the former U.S. parent, and not the CFC's earnings. The potential for future U.S. tax on the CFC's earnings would therefore be preserved. This rule generally applies to related party stock sales completed on or after September 22, 2014, regardless of whether the corporate group has undertaken an inversion.

Prevent Avoidance of the Inversions Toll Charge

The Regulations also foreclose certain transactions that were designed to circumvent the toll charge after a 60% Inversion. Previously, after a 60% Inversion, taxpayers could avoid triggering the punitive toll charge by structuring transactions in which the former U.S. parent is not directly subject to tax – for example, by indirectly transferring properties out from under the U.S. company. The Regulations generally foreclose this strategy by expanding the scope of income that may be subject to the toll charge.

LOOKING AHEAD

The new regulations eliminate some of the key techniques that historically have been used to put a transaction outside of the reach of the inversion rules and also dramatically undercut many of the key tax savings opportunities created by a successful inversion. In some respects, they also reach much farther, potentially impacting situations that do not obviously involve the anti-inversion rules.

Legislators and commentators have questioned the legal authority of the Treasury to issue such broad regulations, particularly regarding earnings stripping. Regardless of the actual legal authority of the Treasury to issue these regulations, there seems a low likelihood that a public company taxpayer contemplating an inversion transaction will challenge the Regulations in court. Given the high stakes involved in such a transaction, the duties owed to shareholders would appear to vastly outweigh the potential gain that could be achieved from waging such a battle with the government.

Even as the Regulations have begun to have their intended effect of at least slowing some inversion activity, Treasury has again reiterated that only legislative action can truly close the door on companies looking to exit the United States. Press coverage in the wake of the new regulations would seem to second Treasury's view: Promptly after the Pfizer/Allergan deal was called off, speculation began as to whether the two companies might simply wait out the lookback period established by the serial acquisition rule, or whether Pfizer might return to its former merger partner, AstraZeneca. Shares of some large foreign pharmaceutical companies were rumored to be trading higher due to speculation that one of them could be the next potential partner for Pfizer or one of its U.S. peers, and articles were already being published in the tax and popular press about the inherent limitations of the Treasury guidance. Commentators also have noted that the Regulations are targeted to specific perceived evils, not to expatriation transactions in general. The door remains open.

Legislative proposals in the recent past have included a lowering of the continuity threshold to 50%, mandating taxation as a U.S. corporation if management and control remains primarily in the U.S. following the inversion, or imposing an exit tax on expatriating companies. At least some of these proposals would apply retroactively, if enacted as proposed. To date, none of these proposals have gained traction. There remains a lack of consensus as to whether inversions are best addressed through such legislative "sticks" or through the "carrot" of comprehensive tax reform that would include a reduction in the corporate tax rate (generally paid for by taxing accumulated offshore earnings at a preferential rate and either requiring or deeming their repatriation). It is unlikely there will be any action, or even clearer direction, on the legislative front until 2017 or later.

Meanwhile, absent further action by Treasury or Congress, the list of possible tax advantages to an inversion transaction has been shortened, but some key benefits remain:

- First, at least for now, the United States continues to tax its corporations on their worldwide income, and at rates that are among the very highest in the world. After an inversion, a group can minimize U.S. tax by putting future growth and earnings outside of the United States.
- Second, the proposed regulations do not address all forms of earnings stripping, but instead focus solely on debt financings. The potential to reduce U.S. earnings through the payment of royalties or other deductible payments remains, subject to general transfer pricing considerations.
- Third, even the restrictions on "hopscotch" loans and other post-inversion restructurings (other than the Earnings Stripping Rules and related party sale rules) will not apply following an inversion in which continuity of ownership by shareholders of the U.S. company is below 60% after application of the new regulations.

The Regulations place a premium on finding a merger partner that is the right size to maximize post-inversion structuring and at the same time make it far more difficult to find such a partner without the tailoring that is now prohibited by the Regulations. The Regulations drastically limit the options for any company that aspires to invert primarily to achieve tax savings. Whether driven primarily by tax or other considerations, any cross-border business combination is a substantial undertaking and investment of financial and management resources. Those stakes only increase as a transaction approaches a merger of equals, as would now be required for a U.S. corporation hoping to sidestep the newly expanded reach of the anti-inversion rules.

For companies in the pharmaceutical and other industries where growth by acquisition has become the norm, however, we would still expect that serious consideration will be given to whether any transaction that might otherwise be undertaken for non-tax reasons might be structured as an inversion transaction. On the right facts (an increasingly narrow universe), an inversion structure continues to offer potential tax savings that can enhance the return from a cross-border business combination.

For any questions with regard to the foregoing matters, please contact any of the authors or your regular Morrison & Foerster tax department contact.

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