

CLIENT UPDATE

U.S. TREASURY DEPARTMENT TO ISSUE RULES TO DETER INVERSION TRANSACTIONS

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The Department of the Treasury issued a notice yesterday describing regulations that it intends to issue to reduce the tax benefits of “inversion transactions.” The regulations would apply to all transactions that close on or after September 22, 2014. There is no grandfathering of signed or announced transactions that have not yet closed. Significantly, the notice only modestly affects “earnings stripping” transactions, where the U.S. tax base is eroded by intercompany debt.

An inversion transaction is an acquisition of a U.S. target corporation by a foreign corporation where (a) former shareholders of the U.S. target own 60% or more of the foreign acquirer after the transaction and (b) the combined entity (including its majority subsidiaries) has less than 25% of its business activity in the country where the foreign acquirer is incorporated. An acquisition of a U.S. target corporation that meets these criteria triggers certain unfavorable tax consequences to the U.S. target, its shareholders, and its offshore subsidiaries. In addition, if the former shareholders of the U.S. target own 80% or more of the foreign acquirer after the transaction, the foreign acquirer will be treated as a U.S. corporation.

The regulations contemplated by the notice would have two key effects. First, they would broaden the category of acquisitions that would be considered inversion transactions by making the 60%

and 80% ownership tests easier to meet. This would occur in a number of ways:

- The new rules would disregard stock of the foreign acquirer that is attributable to passive assets (such as cash or marketable securities) if at least 50% of the foreign acquirer's assets are passive assets, thereby enlarging the portion of the foreign acquirer that is considered owned by former shareholders of the U.S. target corporation after the transaction. There would be an exception for passive assets used in connection with an active banking or financing or a qualifying insurance business.
- The new rules would also disregard "skinny down" distributions made by the U.S. target before the transaction to reduce its size. These would be defined as distributions exceeding 110% of the average of all distributions made by the U.S. target in the 3 years before the year of the transaction.
- Finally, the new rules would limit the ability of a U.S. corporation to engage in a "spinversion," a transaction in which the U.S. corporation contributes a U.S. subsidiary to a newly formed foreign corporation and then distributes the foreign corporation to its shareholders. The new rules would treat the spun off foreign corporation as a U.S. corporation.

Second, the new regulations would limit the U.S. tax benefits of inversion transactions by making it more costly for the foreign acquirer to access untaxed earnings held by offshore subsidiaries of the U.S. target corporation (controlled foreign corporations or "CFCs"):

- Under current law, a loan from a CFC to its U.S. parent corporation is immediately taxable to the U.S. parent, but if the CFC makes the loan to a foreign parent of the U.S. corporation, there are only minor U.S. tax effects. The new rules would cause any such "hopschotch" loans made within 10 years of the foreign parent's acquisition of the U.S. corporation to be immediately taxable to the U.S. corporation, even if it does not receive any cash attributable to such loans.
- The new rules would also eliminate certain techniques currently employed (a) to "decontrol" a CFC (i.e., cause it to lose its CFC status so that it is no longer subject to U.S. tax rules on its earnings) and (b) to enable a foreign parent of a U.S. corporation to access the untaxed earnings of a CFC while bypassing the U.S. corporation.

The notice does not address "earnings stripping" directly. However, the Treasury Department is considering issuing additional guidance that would address earnings stripping strategies, which may apply to inverted companies retroactively to the September 22 effective date. Finally, the Treasury Department has not proposed lowering the 60% ownership threshold for a transaction to qualify as an inversion, as that figure is mandated by statute and would require Congressional action to alter.

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Please do not hesitate to contact us with any questions.

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