

Client Update

Treasury Issues Additional Guidance Relating to Inversion Transactions

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On November 19, 2015, the Treasury Department and the Internal Revenue Service issued Notice 2015-79 (the “Notice”) describing regulations that they intend to issue to curtail inversion transactions and eliminate the benefits of certain post-inversion “tax avoidance” strategies. Although the Notice contains a significant new rule that limits the use of third-country parent companies and may deter certain inversion transactions, it does not fundamentally alter the tax landscape, and indeed permits certain acquisition transactions involving insurance companies that could have been characterized as inversion transactions under earlier guidance. Significantly, the Notice does not address earnings stripping, a strategy whereby the U.S. tax base is eroded following an inversion transaction by intercompany interest charges. The Notice states that Treasury and the IRS continue to consider issuing guidance to address earnings stripping as well as other post-inversion techniques to shift U.S.-source earnings to lower-tax jurisdictions. The Notice is generally effective immediately.

An inversion transaction is an acquisition of a U.S. corporation by a foreign corporation where (a) former shareholders of the U.S. corporation own 60% or more of the stock of the foreign acquirer after the transaction and (b) the combined entity does not have “substantial business activities” in the country where the foreign acquirer is incorporated. An acquisition of a U.S. corporation that meets these criteria triggers certain unfavorable tax consequences to the U.S. corporation, its shareholders and its foreign subsidiaries. In addition, if the former shareholders of the U.S. corporation own 80% or more of the stock of the foreign acquirer after an inversion transaction, the foreign acquirer will be treated as a U.S. corporation for U.S. tax purposes and therefore will be subject to U.S. tax on its worldwide income.

The new rules contemplated by the Notice would broaden the category of acquisitions considered to be inversion transactions, principally by making the 80% ownership test easier to meet if a foreign corporation and a U.S. corporation combine under a parent corporation formed in a third country and, with respect

to inversion transactions that meet only the 60% ownership test, may also increase the U.S. tax cost of certain post-inversion transactions between the U.S. and foreign members of the group.

- **Third-Country Parent Corporation** The new rules would address transactions in which a U.S. corporation and a foreign corporation combine under another foreign corporation (“foreign parent”) that is resident for tax purposes in a third jurisdiction. The rule would disregard, for purposes of the inversion stock ownership test, all of the foreign parent stock held by former owners of the acquired foreign corporation by reason of the acquisition. This rule would only apply if the 60% ownership test would be met without regard to the rule.

As an illustration, assume that a new Dutch corporation acquires a U.S. corporation and a Japanese corporation in exchange for, respectively, 65% and 35% of the stock of the Dutch corporation. Absent the new rules, the 80% threshold would not be met because the former owners of the U.S. corporation would hold only 65% of the stock of the Dutch corporation. Under the new rules, the 35% of the stock of the Dutch corporation held by the former owners of the Japanese corporation would be disregarded, meaning that the ownership fraction would be 65/65 or 100%. The Dutch corporation would be deemed to be a U.S. corporation for U.S. tax purposes and would be taxed on its worldwide income.

- **PFIC Insurance Exception to Cash Box Rule** The new rules would provide relief to foreign insurance companies from the “cash box” rule announced by Notice 2014-52. Under the cash box rule, if more than 50% of the assets of a foreign acquiring group consist of “nonqualified property”, such as cash and marketable securities, the portion of the stock of the foreign acquiring company that corresponds to the value of the nonqualified property is not included in the denominator of the ownership fraction that determines whether the 60% or 80% ownership test has been satisfied, thereby making it more likely that an inversion transaction will occur. Although Notice 2014-52 recognizes that insurance companies hold substantial cash and marketable securities in connection with their business operations and therefore require special treatment for purposes of the cash box rules, Notice 2014-52 only provides a narrow exception for insurance companies based on the controlled foreign corporation (“CFC”) rules.

Treasury and the IRS have recognized that the CFC insurance company exception to the cash box rule could lead to inappropriate results and the

new rules therefore expand the exception to cover assets held by a foreign insurance company that is engaged in the active conduct of an insurance business, determined based on the insurance company exception in the passive foreign investment company (“PFIC”) rules. In addition, the new rules provide that assets held by U.S. insurance company subsidiaries of foreign acquirers generally will not be treated as nonqualified property for purposes of the cash box rules and also provide relief for certain U.S. non-insurance company subsidiaries that are engaged in the insurance business. The Notice tempers the new exception somewhat by noting that Treasury and the IRS continue to have significant concerns about certain foreign corporations that do not conduct a bona fide insurance business or whose investment assets exceed the amount necessary to meet their obligations under insurance and annuity contracts, and that such concerns will be addressed in forthcoming PFIC regulations.

- **Substantial Business Activities** The new rules would prevent a foreign corporation from qualifying for the substantial business activities exception unless the foreign corporation is a tax resident of the foreign country in which it is organized. This change would prevent, for example, an Irish corporation that is centrally managed and controlled from the U.K. and therefore is tax resident in the U.K. from qualifying for the substantial business activities exception.
- **Inversion Gain** Following an inversion transaction that meets the 60% ownership test (but not the 80% ownership test), the inversion rules prevent the U.S. corporation from using net operating losses and other tax attributes to reduce tax on “inversion gain” that is recognized during the 10-year period following the acquisition. This rule is intended to require that the U.S. corporation pay full U.S. tax on property that is transferred or licensed to members of the foreign acquiring group (thereby removing such property from the U.S. taxing jurisdiction) during the 10-year period.

The new rules would expand the definition of inversion gain to include income or gain from certain indirect transfers or licenses of property, including “subpart F” income that the U.S. corporation takes into account under the CFC rules as a result of a transfer or license of property by the CFC to a related foreign entity, thereby potentially increasing the U.S. tax cost of such indirect transfers.

- **Transactions That De-Control or Significantly Dilute Ownership of CFCs** The Notice announced rules that would require a U.S. corporation,

following an inversion transaction, to recognize income with respect to certain non-recognition transactions that dilute the interest of the U.S. corporation in its CFCs, even if income would not be required to be recognized under the regular CFC rules. The amount of income that the U.S. corporation would recognize in these circumstances is equal to the U.S. corporation's share of the earnings and profits of the CFC. The new rules potentially increase the cost of such dilution transactions by subjecting the U.S. corporation to tax on all of the built-in gain in the stock of a CFC that is exchanged in the non-recognition transaction, without regard to the foreign subsidiary's earnings and profits.

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Please do not hesitate to contact us with any questions.