Client Update
Treasury Issues Regulations Imposing Additional Restrictions on Inversion Transactions

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On April 4, 2016, the Treasury Department and the Internal Revenue Service issued temporary regulations (the "Temporary Regulations") intended to curtail tax inversion transactions and to eliminate the benefits of certain post-inversion "tax avoidance" strategies. The Temporary Regulations generally conform to the rules that Treasury and the IRS previously announced in two administrative notices, which were issued in September 2014 and November 2015 (the "Notices"). However, the Temporary Regulations also introduce a significant new rule addressing multiple-step acquisitions of U.S. entities, which has resulted in the termination of the Pfizer-Allergan merger.

The portions of the Temporary Regulations that implement rules described in the Notices generally are effective as of the date of the applicable Notice, while new rules introduced by the Temporary Regulations and modifications to rules described in the Notices generally are effective as of April 4, 2016.

In connection with the issuance of the Temporary Regulations, Treasury and the IRS also issued proposed regulations that would treat certain related party debt instruments as equity for tax purposes, thereby eliminating interest deductions and potentially resulting in other adverse tax consequences. While the proposed regulations have broad application even outside the inversion context, these rules would apply to certain debt instruments that are typically issued by U.S. groups to foreign parents in connection with inversion transactions and that are issued on or after April 4, 2016. We will distribute a separate Client Update concerning these proposed regulations shortly.

An inversion transaction is an acquisition of a U.S. corporation by a foreign corporation if (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. (Similar rules apply to the acquisition of a trade or business of a domestic partnership or LLC.) An acquisition of a U.S. entity that meets these criteria triggers certain unfavorable tax consequences to the U.S. entity, its shareholders and its foreign subsidiaries. In particular, these rules impose U.S. tax costs on strategies that would otherwise allow the foreign acquirer to access undistributed earnings of the U.S. entity's foreign subsidiaries, thereby removing some of the benefits of engaging in an inversion transaction. If the former shareholders of the U.S. entity 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 Temporary Regulations introduce two new rules that broaden the category of acquisitions considered to be inversion transactions by making the 60% and 80% ownership tests easier to meet in the case of companies that engage in multiple inversion transactions.

- Multiple Domestic Entity Acquisitions This rule applies if a single foreign corporation acquires one or more U.S. entities (the previous acquisitions) during the 36-month period that precedes the signing date of an acquisition of another U.S. entity (the relevant acquisition). Under this rule, which is aimed at "serial inverters," the value of the foreign corporation's stock issued to the former owners of acquired U.S. entities in connection with the previous acquisitions is disregarded for purposes of the ownership tests. The 36-month look-back period is a bright-line rule, and therefore any acquisitions of U.S. entities during this period will fall within the scope of the rule, regardless of whether the previous acquisitions were related or part of a single plan.

  If applicable, the multiple domestic entity acquisition rule has the effect of reducing the value of the foreign corporation for purposes of applying the ownership tests, thereby making the 60% and 80% ownership tests easier to meet. (This was the rule that proved problematic for the Pfizer-Allergan merger, as it had the effect of disregarding a significant portion of Allergan's value, namely the portion that related to prior U.S. acquisitions.) This new rule may have a significant limiting effect on future inversion transactions by narrowing the pool of foreign merger partners that have the requisite value to support a transaction that does not exceed the ownership thresholds. The new rule is effective for all relevant acquisitions that occur on or after April 4, 2016, irrespective of when such deals were signed or when the previous acquisitions occurred.

- Multiple-Step Acquisitions The other new rule dealing with multiple transactions applies if a foreign corporation acquires a U.S. entity and, as part of a plan, another foreign corporation subsequently acquires the first foreign acquiring corporation. For purposes of applying the 60% and 80% ownership tests to the second acquisition, the two acquisitions will, in effect, be integrated and a portion of the stock in the second foreign acquiring corporation will be treated as having been issued in exchange for stock of the U.S. entity.

While the Temporary Regulations generally are consistent with the rules that Treasury described in the Notices, the Temporary Regulations provide additional detail on each of the rules.

- Third-Country Parent Corporation The Temporary Regulations address transactions in which a U.S. entity and a foreign corporation (foreign target) combine under another foreign corporation (foreign parent) that is resident for tax purposes in a third jurisdiction. The rule disregards, 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. For example, if a foreign target and a U.S. entity combine under a shell foreign parent that is resident in a third jurisdiction, all of the foreign parent stock, other than stock received by former shareholders of the U.S. entity, will be disregarded, and the ownership percentage will be 100%. This rule only applies if the 60% ownership threshold would be met without regard to the rule, and also will have the effect of limiting inversion transactions by making it less tax efficient for a U.S. entity to combine with a foreign company that is not already resident in a favorable tax jurisdiction.
- The Cash Box Rule Generally, under the so-called 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 corporation that corresponds to the portion of the foreign acquiring group's assets that are nonqualified property is not included in the denominator of the ownership fraction that determines whether the 60% or 80% ownership threshold has been satisfied, thereby making it more likely that an inversion transaction will occur. The Notices provided exceptions to the definition of nonqualified property for insurance and banking companies that hold substantial cash and marketable securities in connection with their business operations.

  The Temporary Regulations retain the cash box rule, including the exceptions to the rule as described in the Notices. Importantly for the insurance industry, the Temporary Regulations retain an exception for foreign insurance companies that are engaged in the active conduct of an insurance business, within the meaning of the passive foreign investment company (PFIC) rules, and a similar exception for domestic insurance company subsidiaries of foreign acquirers that would otherwise be subject to the cash-box rule. However, Treasury and the IRS have announced that they 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.

- Non-Ordinary Course Distributions The Notices provided that non-ordinary course distributions by a U.S. entity in the 36-month period preceding the acquisition of the U.S. entity would be disregarded, thereby making it more difficult for a U.S. entity to make itself smaller in order to satisfy the ownership tests. The Notices defined non-ordinary course distributions as distributions during a year in excess of 110% of the average distributions made in the prior years. The Temporary Regulations clarify that the non-ordinary course distribution rule only takes into account the value of the property distributed at the time of the distribution for purposes of the ownership tests, without a hypothetical return applied to such amount.

Additionally, consistent with the Notices (with minor modifications), the Temporary Regulations limit the U.S. tax benefits of certain post-inversion transactions, in the case of an inversion transaction that satisfies the 60% ownership test. Of particular note, these rules limit foreign acquiring companies from accessing undistributed earnings of foreign subsidiaries of the U.S. entity through so-called "hopscotch loans" or by making investments in such foreign subsidiaries, and also may subject the U.S. entity to additional tax in connection with exchanges of stock or assets of its foreign subsidiaries following the inversion transaction.

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Please do not hesitate to contact us with any questions.