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New Guidance Takes Another Run at Inversions

On November 19, 2015, in light of a resurgence of potential inversion activity, including stories about a possible Pfizer/Allergan merger (which was formally announced this past weekend), the Treasury Department and the Internal Revenue Service (together referred to as the "Service") issued additional guidance (in the form of Notice 2015-79 and a related fact sheet) that is generally intended (i) to broaden the circumstances in which an acquisition of a U.S. corporation by a non-U.S. corporation will be treated as an inversion subject to the most onerous provisions of the inversion rules and (ii) to subject certain post-inversion transactions to additional taxes. Certain changes, including introduction, as described below, of a third-country rule and expansion of the anti-stuffing rule, surprised many practitioners that follow the inversion area. Further changes may follow – the Service has previously stated, and reiterated in connection with the issuance of Notice 2015-79, that it continues to consider issuance of new earnings stripping rules, although it provided no clues as to what these rules might be. Both this and other topics remain to be resolved by future regulations and other guidance. In the meantime, although certain pending transactions may require adjustments in response to the most recent guidance and although future guidance may lead to further adjustments or the loss of certain benefits, we expect that U.S. corporations will continue to plan and implement inversions and similar transactions.

Existing Law

Section 7874 treats a non-U.S. corporation as a "surrogate foreign corporation" if (i) the non-U.S. corporation acquires substantially all of the properties held by a U.S. corporation, (ii) at least 60 percent of the stock of the non-U.S. corporation is treated as being held by former shareholders of the U.S. corporation by reason of holding stock in the U.S. corporation and (iii) the expanded affiliated group including the non-U.S. corporation (the "EAG") does not have "substantial business activities" in the non-U.S. country in which the non-U.S. corporation is organized (any such transaction, an "inversion").

If former shareholders of the U.S. corporation are treated as owning 80 percent or more of the stock of the surrogate foreign corporation (an "80 percent inversion"), the surrogate foreign corporation will be treated as a U.S. corporation for U.S. tax purposes. This rule generally has been treated as an impassable barrier to any transaction in which former shareholders of the U.S. corporation would be treated as owning 80 percent or more of the stock of the surrogate foreign corporation.

If former shareholders of the U.S. corporation are treated as owning at least 60 percent but less than 80 percent of the stock of the surrogate foreign corporation (a "60 percent inversion"), the surrogate foreign corporation will not be treated as a U.S. corporation. Instead, the U.S. corporation will be required to pay tax with respect to its "inversion gain", and certain directors and officers of the U.S. corporation will be subject to an excise tax on stock-based compensation. While burdensome, this set of rules, together with the rules generally taxing U.S. shareholders on cross-border mergers where the U.S. party to the merger is larger than the foreign party and additional rules imposed by prior guidance from the Service in September 2014 (Notice 2014-52), has not operated as an absolute impediment to inversions. In the past year, multiple U.S. corporations have completed transactions that were treated as 60 percent inversions (*e.g.*, Mylan-Abbott Laboratories).

What the New Rules Do

Last year's guidance and this new Notice represent the Service's ongoing efforts to stem the tide of inversions. The first Notice undoubtedly slowed the pace of transactions, and is widely credited with having prevented the AbbVie-Shire merger. But it certainly did not stop all cross-border merger activity that comes under the scrutiny of the inversion rules. During 2015, Steris, Wright Medical and Mylan, among others, have also moved forward with their mergers. The new Notice represents the Service's further effort to expand or more clearly define the transactions that are on the wrong side of the 80 percent dividing line, and to make it more difficult for those transactions that survive this first hurdle to take advantage of their new status by reducing or eliminating their U.S. taxes on undistributed earnings and untaxed appreciation in the stock or assets of their non-U.S. subsidiaries.

Testing for Inversion Status

In prior guidance, the Service had developed anti-avoidance rules that may increase the percentage of stock of the non-U.S. corporation treated as acquired by former shareholders of the non-U.S. corporation for purposes of determining whether a transaction is a 60 percent or 80 percent inversion. The Notice takes significant further steps in that direction.

Third-Country Transactions. Before the Service issued Notice 2015-79, while a substantial non-U.S. counterparty generally was necessary to avoid an 80 percent inversion, the non-U.S. counterparty could be located in any non-U.S. jurisdiction, and the new parent of the combined group could be located in a third jurisdiction. See, e.g., the combination of Endo International (U.S.) and Paladin Labs (Canada) under Endo International (Ireland) or the proposed combination of Applied Materials (U.S.) and Tokyo Electron (Japan) under a Netherlands holding company (abandoned for antitrust reasons). The Service asserts that any such third-country parent typically is chosen for U.S. tax avoidance reasons rather than business or legal reasons, although the Service has not provided any support for this factual conclusion. On this basis, Notice 2015-79 provides that stock of a third-country parent issued to shareholders of a non-U.S. target will be disregarded for purposes of determining whether a transaction is an 80 percent inversion, if (i) the third-country parent acquires substantially all of the properties held by the non-U.S. target, (ii) the gross value of all property acquired by the third-country parent exceeds 60 percent of all "foreign group property", (iii) the tax residence of the third-country parent is not the same as that of the non-U.S. target, and (iv) before taking into account this rule, the transaction would be a 60 percent inversion.

As a result, for example, a new U.K. holding company that acquires a French target in exchange for 40 percent of its stock and a U.S. target in exchange for 60 percent of its stock will be treated as a U.S. corporation. This rule may be overbroad, at least as applied to a transaction in which the taxpayer articulates real and substantial business reasons for the use of the new holding company (for example, because the combined group has substantial business activities in the U.K., is managed and controlled from the U.K., or prefers a U.K. holding company for legal, regulatory or trade reasons). Nevertheless, the new rule leaves no room for such cases. Furthermore, the Service has not proposed any definition of "substantially all" in the inversion context. In the absence of a definition, taxpayers will be left in an uncertain position regarding transactions in which a non-U.S. parent acquires a portion of the assets of a target or which occur after other transactions that expanded or contracted the assets of the target. Interestingly, the adoption of the third-country rule may give a "first mover" advantage to those who have already completed a successful third-country inversion.

Expanded and Modified "Anti-Stuffing" Rule. Because an inversion may avoid the most severe U.S. tax consequences if the shareholders of the U.S. corporation acquire less than 80 percent of the non-U.S. corporation, the inversion statute, amplified by the earlier guidance, anticipates that taxpayers may search for methods to increase the amount of stock of the non-U.S. corporation acquired in exchange for other assets. In this regard, the Service previously promulgated temporary regulations including an "anti-stuffing" rule that disregards stock of a non-U.S. corporation acquired in exchange for passive assets or other assets (referred to as "avoidance assets") acquired with a principal purpose of avoiding the purposes of the inversion rules.

The Service has now said that it plans to amend the temporary regulations to clarify that the term "avoidance assets" should be interpreted broadly. They have provided a new example of the application of the anti-stuffing rule in which a non-U.S. partnership transfers active business assets to a new non-U.S. corporation, and the shareholders of a U.S. corporation transfer all of the stock of the U.S. corporation to the same non-U.S. corporation. The example assumes without analysis that the active business assets were acquired "with a principal purpose of avoiding the purposes of Section 7874." As a result, the former shareholders of the U.S. corporation are deemed to acquire 100 percent of the stock of the non-U.S. corporation, resulting in the treatment of the non-U.S. corporation as a U.S. corporation for U.S. tax purposes. This rule creates a risk that *any* cross-border transaction in which a new non-U.S. holding company acquires both a U.S. corporation and a non-U.S. corporation could be viewed as being undertaken for a principal purpose of avoiding the inversion rules. If one disregards the stock issued to shareholders of the foreign party—even, for example, in a 50-50 merger—the transaction would be an 80 percent inversion. In the absence of any further guidance, parties to cross-border mergers and their tax advisors will be required to carefully examine their ability to establish the difficult-to-prove proposition that avoiding the inversion rules was not one of their principal purposes.

Substantial Business Activities. Both the inversion statute and prior inversion rules tested whether the EAG of the non-U.S. parent had substantial business activities by focusing on the jurisdiction in which the non-U.S. parent was organized, but some non-U.S. jurisdictions apply different tests to determine whether a business entity is treated as a resident corporation subject to tax. The Service is concerned that the prior rules may have permitted transactions contrary to the policy of the substantial business activities test to escape the inversion rules by using a non-U.S. parent that is not subject to tax as a resident in the jurisdiction in which it is organized. As a result, the Notice provides that an EAG will not be treated as having substantial business activities in the relevant non-U.S. jurisdiction unless the non-U.S. parent is subject to tax as a resident of the applicable non-U.S. jurisdiction. In practice, inversions relying on these rules are relatively rare, because the requirements (25 percent of payroll, headcount, tangible assets and gross income in the relevant country) are difficult for most businesses to meet. Accordingly, this change seems unlikely to have a significant impact on the cross-border merger market.

Relaxed Application of Extraordinary Distributions Rule. Notice 2014-52 announced a rule disregarding certain extraordinary distributions by a U.S. corporation during the 36-month period ending on the date of a potential inversion. This rule may increase the percentage of the non-U.S. corporation treated as acquired by the former shareholders of the U.S. corporation and therefore trigger the adverse tax consequences applicable to inversions. As stated, the rule could have led to an 80 percent inversion in a transaction that resulted in the former shareholders of the U.S. corporation owning little or no stock of the acquirer. In Notice 2015-79, the Service proposed a *de minimis* exception to this rule that would apply if former shareholders own less than 5 percent of the stock of the non-U.S. corporation, without regard to the extraordinary distributions rule.

Additional Taxes Applicable to Out-from-Under Transactions. Absent earnings stripping, inversions do not decrease the taxes paid by the former U.S. parent and its U.S. subsidiaries, which remain subject to U.S. tax jurisdiction. Furthermore, unless the taxpayer engages in additional restructuring, the non-U.S. subsidiaries of the former U.S. parent will continue to be treated as controlled foreign corporations ("CFCs"), and the former U.S. parent will be subject to U.S. taxation with respect to actual or deemed distributions of the income of the CFCs. An inversion may enable further transactions that reduce or eliminate U.S. ownership of non-U.S. operations, thereby avoiding the CFC rules and permitting distribution of non-U.S. income to the non-U.S. parent without incurring U.S. tax (such transactions, "out-from-under transactions").

In Notice 2014-52, the Service announced certain rules intended to subject out-from-under transactions to additional taxes. The Service has now refined and expanded these rules, as described in greater detail below. However, taxpayers have demonstrated a willingness to work through complex restrictions regarding out-from-under transactions and to bear certain current costs in order to achieve the long-term benefits of an inversion. We expect that international tax planners will continue to develop cost-saving out-from-under transactions, and that the Service will continue to expand its guidance in this area to block or reduce the benefits of these transactions.

- *Expanded Definition of Inversion Gain*. Under current law, inversion gain does not include income of a CFC that is deemed to be distributed to the U.S. shareholder of the CFC. The Service intends to expand the definition of inversion gain to include income or gain recognized from an indirect transfer or license of property.

- *Expanded Taxation of Built-in Gain in Foreign Subsidiaries*. Under current regulations, certain out-from-under transactions will cause the U.S. owner of a CFC to be subject to tax on a current basis with respect to the undistributed earnings and profits of the CFC. The Service now intends to amend the applicable regulations to require the U.S. owner to recognize all of its built-in gain in the stock of a CFC, without regard to the amount of earnings and profits.

- *Clarification of Small Dilution Exception*. In Notice 2014-52, the Service announced an intention to issue regulations recharacterizing certain out-from-under transactions as taxable dispositions of CFC stock, with an exception for transactions in which the amount of stock owned by U.S. shareholders does not decrease by more than 10 percent. The Service has now clarified that this exception must be applied by comparing the percentage of the CFC stock owned by U.S. shareholders before and after the transaction.

What the Notice Does Not Do

Notwithstanding the general anti-inversion trend, the Service has noted that current law does not provide authority to block all transactions that result in a U.S. corporation being owned by a non-U.S. parent. Section 7874 applies only to 60 percent inversions and 80 percent inversions. The Notice does not change these rules, and indeed, even the new third-country rule applies only to transactions that would have been 60 percent inversions without application of the rule. Furthermore, subject to the modification described above, the "substantial business activities" exception will still permit a multinational group with a U.S. parent to invert to a jurisdiction in which 25 percent of the group employees, group assets, and group income are located. As a result, for a U.S. corporation that can thread its way through these complex and evolving rules, inversions and similar transactions should continue to offer substantial tax benefits.

Effective Date. The new rules generally apply to all transactions completed on or after November 19, 2015. The rules applicable to post-inversion transactions apply if the inversion was completed on or after September 22, 2014, and the post-inversion transaction is completed on or after November 19, 2015. Accordingly, a taxpayer that completed an inversion between September 22, 2014 and November 19, 2015, but that has not yet completed its post-inversion transactions, may find that the tax benefits are less than originally expected. Taxpayers may elect to apply the clarifications and corrections of prior guidance to transactions completed before November 19, 2015.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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