# Treasury and IRS Issue Anti-Inversion Guidance

On September 22, 2014, the Treasury Department (the "Treasury") and the Internal Revenue Service (the "IRS") issued Notice 2014-52 (the "Notice"), announcing their intention to issue new regulations regarding inversions. The new regulations, which generally will apply retroactively to transactions occurring on or after September 22, 2014, are intended: (1) to make it more difficult to avoid the principal anti-inversion rule of Section 7874 of the Internal Revenue Code ("Section 7874"), which recharacterizes the non-U.S. acquiror in an inversion as a U.S. corporation if certain conditions are met, and (2) for inversions that continue to avoid the principal anti-inversion rule of Section 7874, to make such inversions less attractive by denying the benefits of certain post-inversion tax planning. The Notice also provides that the Treasury and the IRS are considering additional guidance to address other tax reduction strategies used by non-U.S. corporations with U.S. subsidiaries, such as earnings stripping through intercompany debt (and notes that any such future guidance that is targeted to inversions will apply retroactively to inversions occurring on or after September 22, 2014).

## I. What is an Inversion?

An inversion transaction is a transaction in which a U.S. corporation or, in certain cases, a U.S. partnership (a "U.S. target") changes its domicile to a non-U.S. jurisdiction (*e.g.*, by reincorporating in a non-U.S. jurisdiction) or becomes a subsidiary of a non-U.S. corporation (*e.g.*, by being acquired by a non-U.S. corporation) and the ultimate equity ownership of the U.S. target does not change to a significant extent. Under Section 7874, if the former shareholders of the U.S. target are deemed to own at least 80% of the stock of the redomiciled U.S. target or the non-U.S. acquiror (each, a "non-U.S. acquiror"), the non-U.S. acquiror generally will be recharacterized as a U.S. corporation for U.S. federal income tax purposes, unless the non-U.S. acquiror and its subsidiaries (the non-U.S. acquiror group") are deemed to have substantial business activities in the jurisdiction of the non-U.S. acquiror.[1] If the 80% test of Section 7874 applies, the U.S. target is effectively unable to move offshore.

If the former shareholders of the U.S. target are deemed to own at least 60% (but less than 80%) of the stock of the non-U.S. acquiror and the group does not have substantial business activities in the jurisdiction of the non-U.S. acquiror, Section 7874 imposes some requirements and limitations on the U.S. target (or its successor), but the inversion achieves its principal tax objective – the non-U.S. acquiror will be respected as a non-U.S. entity for U.S. federal income tax purposes. Many high profile transactions in the last few years have been structured to come within this 60% to 80% range, and there have been various proposals to expand the principal rule of Section 7874 to cover such transactions (*e.g.*, by lowering the 80% ownership threshold to 50%). To date, none of these proposals have garnered enough support in Congress to be enacted into law.

## II. What does the Notice do?

### A. *Make it more difficult to stay below the 80% ownership threshold*

New regulations to be issued pursuant to the Notice will, in certain instances, make it more difficult to stay below the 80% ownership threshold. For purposes of determining whether the 80% ownership threshold is met:

[1] For this purpose, the non-U.S. acquiror group generally will be treated as having substantial business activities in the relevant foreign country only if (a) at least 25% of the group's employees and the group's employee compensation are based in the foreign country, (b) at least 25% of the group's assets (by value) are located in the foreign country, and (c) at least 25% of the group's income is derived in the foreign country.

- If more than 50% of the gross value of a non-U.S. acquiror group's assets consist of cash, marketable securities, obligations of certain affiliates or certain other property intended to circumvent the application of Section 7874, a portion of the non-U.S. acquiror's outstanding stock will be disregarded. This rule will not apply to certain financial institutions.

- Certain extraordinary dividends paid by the U.S. target during the 36-month period before the inversion, which would otherwise have "skinnied down" and reduced the value of the U.S. target, will be disregarded. Distributions during a taxable year generally will be treated as extraordinary dividends for this purpose to the extent that such distributions exceed 110% of the average annual distributions made during the 36-months preceding such taxable year.

- A favorable rule that applies to internal group restructurings will not apply where a U.S. parent contributes a U.S. subsidiary to a non-U.S. entity in exchange for a controlling stake in such non-U.S. entity and then spins off such non-U.S. entity to the U.S. parent's shareholders (a "spinversion").

***B. Deny the benefits of certain post-inversion tax planning***

For inversions that stay below the 80% ownership threshold but (1) are within the 60% to 80% ownership range and (2) do not meet the substantial business activities test, new regulations to be issued pursuant to the Notice will deny the benefits of certain post-inversion tax planning. These new regulations will target transactions that would otherwise permit a non-U.S. acquiror to access accumulated earnings and profits of a controlled foreign subsidiary ("CFC") of the U.S. target, without ever incurring any U.S. federal income tax. As noted below, the third change will apply more broadly, even where no inversion is involved.

- If made during the ten year period following an inversion, "hopscotch loans" by a CFC of the U.S. target to the non-U.S. acquiror (or certain non-U.S. persons related to the non-U.S. acquiror) or similar equity investments will be subject to the same deemed dividend rules as if the CFC had made loans to or equity investments in the U.S. target. The same rule will apply to guarantees by such a CFC (or pledges of more than 66⅔ of such a CFC's voting stock) in respect of obligations of the non-U.S. acquiror (or certain non-U.S. persons related to the non-U.S. acquiror).

- Certain restructuring transactions undertaken during the ten-year period after the inversion transaction that are aimed at "de-controlling" CFCs of the U.S. target (so that such non-U.S. subsidiaries would no longer be treated as CFCs) will be disregarded, so that such foreign subsidiaries of the U.S. target will continue to be treated as CFCs (and the U.S. target will remain subject to potential U.S. federal income tax on the undistributed earnings and profits of such non-U.S. subsidiaries).

- Rules governing the treatment of certain related party stock sales will be modified to prevent a CFC's deferred earnings from being repatriated without the imposition of U.S. federal income tax. This change would apply, for example, to a sale by a non-U.S. acquiror of U.S. target stock to a CFC of the U.S. target, in exchange for cash or property of the CFC, but would also apply more generally to transactions between non-U.S. parents, U.S. subsidiaries and CFC subsidiaries of the U.S. subsidiaries, even in the absence of an inversion transaction.

## III. Likely Impact of the Notice

The changes to the 80% ownership threshold are fairly narrow in scope but, if applicable, may stop an otherwise viable transaction from proceeding. The impact of the changes aimed at denying the benefits of certain post-inversion tax planning will vary from case to case but may, in some instances, be significant and should be carefully considered in assessing the benefits of any potential inversion.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Craig Horowitz at 212.701.3856 or chorowitz@cahill.com; or Ann Creed at 212.701.3876 or acreed@cahill.com.

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