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Treasury Issues Long-Awaited Anti-Inversion Guidance

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The Treasury Department and the IRS yesterday released Notice 2014-52 (the "Notice"), which describes regulations that the government intends to issue to target the tax benefits of corporate inversions, including for pending transactions. These rules would generally apply to any inversion transaction in which the shareholders of the U.S. corporation own 60% or more of the stock of the combined company and which does not satisfy the "substantial business activities" exception in Section 7874 if the transaction closes on or after September 22, 2014 (the issue date of the Notice), with no grandfathering provision for signed but not yet completed transactions. Following weeks of robust public discussion as to the extent of Treasury's authority to issue anti-inversion regulations, the Notice goes to great lengths—more so than most IRS notices—to identify and develop Treasury's case for the underlying legal authority for the contemplated regulations. Notably, the Notice does not contain any earnings-stripping rules.

The following is a summary of the provisions in the Notice.

Impose U.S. Tax on Hopscotch Loans

Under current law, an inverted company can access cash that had previously been trapped in the foreign subsidiaries of the U.S. corporation by having those foreign subsidiaries make a "hopscotch" loan of the cash to the new foreign parent or foreign affiliates. The Notice reduces substantially the ability of an inverted U.S. company to access the trapped cash to fund the inversion without a U.S. tax cost by treating any "hopscotch" loans (and stock investments) made within 10 years after an inversion transaction as an investment in "United States property" that gives rise to a taxable deemed dividend to the U.S. corporation. Notably, the amount of the deemed dividend is not limited to the amount of the foreign subsidiary's pre-inversion earnings, but can also include post-inversion earnings. While Treasury and the IRS requested comments on appropriate exceptions, a current law exception for short-term obligations would not apply.

Prevent Tax-Free Decontrol of Foreign Subsidiaries

Under current law, after an inversion, the inverted company can implement tax planning strategies to avoid U.S. tax on the pre-inversion earnings of controlled foreign subsidiaries of the U.S. corporation by causing the U.S. corporation to lose control of those foreign subsidiaries. The Notice addresses this type of planning by recharacterizing the transaction. If, within 10 years after the inversion transaction, stock of a controlled foreign subsidiary of the U.S. corporation is transferred (including by way of a new issuance) to a foreign affiliate (or a U.S. pass-through that is owned by a foreign affiliate) that is not itself controlled by a U.S. corporation in exchange for property, the Notice treats the transaction as if:

- the property was transferred by the uncontrolled foreign affiliate to the U.S. corporation in exchange for instruments deemed issued by the U.S. corporation, and
- the U.S. corporation in turn contributed the property to its controlled foreign subsidiary in exchange for stock of the controlled foreign subsidiary.

The deemed instrument issued by the U.S. corporation would have the same terms as the stock issued by its controlled foreign subsidiary. As a result, if the controlled foreign subsidiary makes a distribution on the stock that was, in form, issued to the uncontrolled foreign affiliate, it would be treated as a distribution to the U.S. corporation (subject to U.S. tax to the extent the earnings have not already been taxed in the United States) and then a distribution from the U.S. corporation to the foreign affiliate (which would potentially be subject to U.S. dividend withholding tax). Note that, again, the rules do not appear to limit the resulting U.S. tax to pre-inversion earnings or to distributions that occur within the 10-year period. However, a transaction will not be recharacterized under this rule if:

- the person who transferred shares of the controlled foreign subsidiary recognized all of the gain in the shares (including gain treated as a dividend) or is treated as having received a deemed dividend with respect to the shares; or
- after the transaction, the foreign subsidiary is still treated as "controlled" by U.S. shareholders and the amount of the stock owned by the U.S. shareholders does not decrease by more than 10 percent.

The Notice also expands the situations in which dividend income is included by the U.S. corporation on an exchange (for instance, where a U.S. corporation exchanges stock of a controlled foreign subsidiary for stock of a foreign affiliate and, after the exchange, both the original foreign subsidiary and the foreign affiliate are controlled by the U.S. corporation). The Notice also states that Treasury and the IRS are considering exceptions if the transaction is undertaken to integrate the businesses and the group does not use the transaction to avoid U.S. taxation on the pre-inversion earnings during the 10-year post-inversion period. These rules, in conjunction with the hopscotch loan rule, are designed to ensure that pre-inversion earnings are taxed in the United States, though a recharacterization could result in greater U.S. tax than the tax that would have been due with respect to the pre-inversion earnings.

Avoid Use of Stock Sales to Repatriate Foreign Subsidiary Earnings

Stock sales to affiliates are generally taxed as dividends for U.S. federal income tax purposes. According to the Notice, taxpayers may be engaging in transactions in which, after an inversion, the new foreign parent sells stock of the U.S. corporation to a controlled foreign subsidiary of the U.S. corporation for cash or property as a means of repatriating the controlled foreign subsidiary’s earnings without U.S. tax. Taxpayers may be taking the position that, under the applicable U.S. tax rules, in certain circumstances the transaction is treated as giving rise to a dividend from the controlled foreign subsidiary directly to the new foreign parent, thereby reducing the amount of the subsidiary’s earnings without any U.S. tax. The Notice would generally prevent this result and preserve the full amount of the controlled foreign subsidiary’s earnings that are subject to U.S. tax when repatriated or deemed repatriated. This rule would apply regardless of whether there was in fact an inversion transaction if there is a U.S. corporation sandwiched between a foreign parent and a foreign subsidiary and the U.S. corporation’s stock is sold to the foreign subsidiary.

Strengthen the Less Than 80% Continuity Test

Most inverted companies rely on the “less than 80%” continuity test in Section 7874 to avoid the continued treatment as a U.S. corporation. The Notice tightens this test the following ways:

- The Notice provides that an amount of stock proportionate to its percentage of passive assets will be excluded from the calculation of the continuity percentage if at least 50% of the foreign acquirer's assets are passive assets (taking into account the assets of the subsidiaries in its group). Passive assets for this purpose include cash and marketable securities. The Notice provides that certain financial institutions will be excepted from this rule.
- The Notice attacks pre-inversion tailoring transactions by disregarding pre-inversion extraordinary dividends made during the 36-month period ending on the acquisition date for purposes of applying the less than 80% continuity test and the Section 367 substantiality rule. Extraordinary dividends mean the excess of all distributions during a taxable year over 110% of the average of such distributions during the 36 months prior to such taxable year, and include distributions that are not treated as dividends (such as spin-offs). In addition, a distribution includes any transfer of money or property to the U.S. corporation's shareholders to the extent that the money or property

is provided directly or indirectly by the U.S. corporation. Thus, if the U.S. corporation's balance sheet provided the funding in the inversion, directly or indirectly, for cash consideration paid by the foreign acquirer to the U.S. corporation's shareholders, the cash would be treated as a distribution for this purpose.

No Exception for Certain Types of Spinversions

The Notice provides that if stock of the foreign acquiring corporation is received by a former corporate shareholder or partner of the inverting U.S. company and that stock is subsequently transferred, it will not be treated as held by a member of the expanded affiliated group for purposes of an exception to the inversion rules. This provision is intended to stop U.S. companies from transferring assets to a newly formed foreign corporation and then spinning off that foreign corporation to its public shareholders. There are exceptions for an internal spin-off in a U.S. parented group and for a spin-off out of a foreign parented group.

Effective Dates

The Notice provides that all of the regulations will apply to inversions that close on or after September 22, 2014. In addition, the rule about sales of U.S. company stock to a foreign subsidiary will apply to any such stock sale completed on or after that date.

Additional Guidance

The Notice states that Treasury and the IRS expect to issue additional guidance to further limit inversion transactions that are contrary to the purposes of Section 7874 and the benefits of post-inversion tax avoidance transactions, and specifically notes that earnings-stripping structures remain under consideration. Although the Notice states that future guidance generally will apply prospectively, the Notice also states that any tax avoidance guidance that applies only to inverted groups would be expected to apply to groups that completed inversion transactions on or after September 22, 2014.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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