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Litigator's Perspective

BY DEVON BODOH AND KEVIN M. JACOBS¹

How Bankruptcy Restructurings Trigger Inversion Tax Risks

Bankruptcy professionals excel in navigating complex negotiations and tight deadlines, but hidden tax traps — such as the “inversion trap” under § 7874 of the Internal Revenue Code, which can apply in cross-border bankruptcy restructurings — can disrupt even the best-laid plans.² This trap can create significant unexpected tax consequences, derail future deals, and leave lawyers, financial advisors and clients scrambling.

This article explains what the inversion trap is, why it matters for non-tax professionals, and the practical steps to avoid costly surprises. It also breaks down the rules in plain language and highlights bankruptcy scenarios where tax risks lurk.

The Inversion Trap: What Is It?

An “inversion” happens when “substantially all” of a U.S. corporation’s assets³ end up being owned by a foreign corporation, often through a stock or asset acquisition, or some combination of both.⁴ Companies might pursue an inversion for lower taxes or global capital access but must adhere to strict Internal Revenue Service (IRS) rules to avoid a costly mistake. There is no special exemption for bankruptcy or insolvency under the inversion rules — meaning that even a routine restructuring can trigger them, even if tax-planning was not the goal.

How Inversions Are Triggered

Three primary tests must be met for the inversion rules to apply.

“Substantially All” Assets Acquired Test (A Domestic-Entity Acquisition)

The first test is met if a foreign corporation acquires “substantially all” of a U.S. company’s assets. In bankruptcy, this can happen unintentionally, such as through asset sales (including § 363 of the Bankruptcy Code) or reorganizations.

Ownership-Fraction Test

If former shareholders of the U.S. entity end up owning 60 percent or more (by vote or value) of the foreign acquirer, the second test is met.

The “Creditor Rule”: Under the “creditor rule,”⁵ creditors can be treated like shareholders in bankruptcy or insolvency scenarios, which often surprises non-tax professionals and can have unexpected consequences: (1) creditors receiving stock in satisfaction of debt may count toward the 60 percent ownership threshold (the IRS treats them as shareholders for this purpose); and (2) multiple creditors or entities can quickly push ownership over the limit due to the application of nuanced aggregation rules.

For example, a foreign acquirer purchases substantially all of the assets of a bankrupt U.S. company. Creditors receive stock in the foreign acquirer. If those creditors collectively own 60 percent or more, the inversion rules could apply — even if the original shareholders are wiped out.

Other Potential Traps: In some circumstances, convertible debt, “disqualified stock,” nonordi-



Devon Bodoh
Weil, Gotshal &
Manges LLP
Washington, D.C.,
and Miami



Kevin M. Jacobs
Alvarez & Marsal
Tax, LLC
Washington, D.C.

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2 Even if the inversion trap is carefully navigated, § 382 of Internal Revenue Code's change-of-control rules might still apply to limit the use of tax attributes, including net operating losses.

3 The inversion rules can apply to partnership structures, including so-called “Up-C structures,” if the foreign corporation acquires substantially all of “the properties constituting a trade or business of a domestic partnership.” The rules governing the acquisition of partnership assets are even more complex than the rules governing corporations and are beyond the scope of this article.

4 The inversion rules take into account a series of related transactions, thus individual steps are not evaluated in isolation.

5 Treas. Reg. § 1.7874-2(i)(2).

nary-course distributions, assumed liabilities and other indirect transfers can result in an ownership percentage exceeding 60 percent (or 80 percent) when, at first blush, the percentage is considerably less (or even 0 percent). In addition, the IRS may apply the step-transaction doctrine, collapsing pre-transaction steps into a single inversion event.

Substantial Business Activities Test

If a foreign corporation's expanded affiliated group (all related companies under common control) does not have substantial business activities in the foreign acquiring corporation's country of formation, the third inversion test is met. "Substantial business activities" generally means at least 25 percent of the expanded affiliated group's employees, assets and income. Because of how the rules work, including the application of aggregation rules, most new foreign holding companies (or multinational groups) will not meet this test. While it is a useful tool, do not rely on this test without rigorous analysis and substantiation.

Tax Consequences of Triggering an Inversion

If a bankruptcy transaction triggers the inversion rules, the tax consequences can be severe and often permanent. If former shareholders hold at least 60 percent, but less than 80 percent, of the foreign acquirer:

- The foreign acquirer remains a foreign corporation for U.S. tax purposes;
- Some income from the transaction will be taxed in the U.S., including certain gains recognized during the 10-year period following the inversion;
- Deductions (*i.e.*, interest expense) might be limited and exposure to the base erosion and anti-abuse tax might increase;⁶
- The foreign acquirer's distributions of earnings to its U.S. investors will not qualify for qualified dividend income treatment (income that is taxed at the preferential capital gains rates instead of ordinary rates); and
- Net operating losses or other tax attributes might be restricted.

If the former shareholders hold at least 80 percent of the foreign acquirer:

- The foreign acquirer is treated as a U.S. corporation for all U.S. tax purposes. It is as if the company moved its assets into the U.S. (or never left), which could trigger immediate taxes on past profits and wipe out prior tax benefits.
- The entire group's worldwide income becomes taxable in the U.S., eliminating the benefit of

moving offshore and creating major compliance and cash tax challenges. This also potentially subjects the foreign acquirer to tax in its home jurisdiction, as well as in the U.S.⁷

Reversing the consequences of the inversion rules is extremely difficult — if not impossible. Losing tax benefits — and even worse, subjecting the acquiring parent's group's worldwide income to U.S. income taxation — can make the restructuring less attractive or even unworkable. Discovering inversion risk late in the deal process can cause delays, renegotiations or legal disputes.

Common Bankruptcy Scenarios that Create Inversion Risk

Bankruptcy restructurings often involve foreign buyers, debt-for-equity swaps or offshore holding companies. These can unintentionally trigger the inversion trap, even when tax planning is not the goal. You should watch out for these common situations.

Foreign Acquisitions of U.S. Assets or Stocks

When a foreign company acquires most or all of a U.S. business's assets, the deal can cross the inversion threshold if former shareholders — including creditors — end up owning 60 percent or more of the foreign acquirer.⁸ *What to Watch Out for:* deals where creditors or former shareholders receive equity in a foreign acquirer, especially if their combined stake could approach or exceed 60 percent. Consider § 363 cash-only or credit-bid sales to reduce exposure.

Chapter 11 Plan with a Foreign Parent

Restructuring plans that involve a foreign parent company can create unexpected inversion risk because the IRS treats certain creditors as "historic shareholders." If those creditors receive equity in the foreign parent, their ownership may push the deal over the 60 or 80 percent thresholds. *What to Watch Out for:* equity allocations to creditors in a foreign parent. Pay close attention to how much ownership creditors receive, as aggregation can quickly reach critical thresholds. The analysis for this scenario can be detailed and yield surprising results.

Debt-for-Equity Swaps

Swapping debt for equity is common in bankruptcy, but when the equity is in a foreign parent, the IRS might treat creditors as owners of that parent. Multiple creditors receiving shares

Devon Bodoh is a partner with Weil, Gotshal & Manges LLP in Washington, D.C., and Miami. He is head of the firm's M&A Tax and International and Cross-Border Tax Practices, as well as the co-managing partner of its Miami office. Kevin Jacobs is a managing director of Alvarez & Marsal Tax, LLC in Washington, D.C., and the National Tax Office practice leader and the U.S. Restructuring Tax Services co-practice leader.

⁶ The base erosion and anti-abuse tax reduces the U.S. tax benefits of certain payments (e.g., interest and royalties) made by U.S. companies to related foreign parties, including a foreign parent.

⁷ The recharacterization as a U.S. corporation is only for U.S. federal income tax purposes, and as such, foreign jurisdictions will continue to treat the foreign acquirer as a non-U.S. corporation, thereby subjecting its income to their tax laws.

⁸ Even if former shareholders own less than 60 percent of the foreign acquirer, special IRS rules, including those for non-ordinary-course distributions, can push the ownership percentage above the threshold.

can quickly aggregate into a controlling stake. *What to Watch Out for:* multiple creditors receiving equity in a foreign parent. Aggregate their ownership to see if the 60 or 80 percent thresholds could be met, potentially triggering the inversion rules.

Prepackaged Plans with Offshore Holding Companies

Newly formed foreign holding companies are often used by prepackaged plans. These entities rarely satisfy the “substantial business activities” requirement to avert the application of the inversion rules. *What to Watch Out for:* foreign holding companies with little or no operational business activity in their home country. If they are unlikely to have substantial business activities in their home country, consider possibly changing the domicile of the foreign parent.⁹

Debt Consolidation Under a Foreign Parent

Combining debt and assets under a foreign parent can inadvertently result in that parent acquiring control over “substantially all” U.S. assets. This scenario often arises in multi-entity restructurings or cross-border consolidations. *What to Watch Out for:* situations where a foreign parent ends up with effective control of U.S. assets. Review ownership and business activity tests to determine whether inversion exposure exists. In restructurings involving multiple U.S. entities or foreign acquirers, aggregation rules could apply, increasing the risk of triggering the inversion rules.

Practical Steps to Avoid the Inversion Trap

Navigating the inversion trap requires taking smart, proactive steps throughout the restructuring process. Bankruptcy attorneys should spot the following tax risks from the outset:

- *Spotting inversion risk early is essential.* In cross-border deals, the technical requirements of the inversion rules apply regardless of business intent. Do not wait until the final stages; raise the issue as soon as a foreign entity or complex ownership structure is on the table.
- *Assess tax implications as part of your initial restructuring plan.* When designing plans or structuring § 363 sales, include a tax review at the start. This helps prevent surprises and ensures that all parties understand the potential consequences.
- *Model ownership and equity allocations before finalizing any deal.* Scrutinize how shares or interests will be distributed, especially under the ownership-fraction test. Analyzing the ownership percentages and reviewing the company’s history early can reveal whether you are close to triggering the 60 or 80 percent thresholds.
- *Keep thorough records of your business purpose and every step of the transaction.* Good documentation is not just best practice; it is your defense if the IRS comes calling. Detailed notes and clear expectations can make all the difference in an audit or dispute.

- *Be transparent about inversion risk in disclosure statements and court filings.* Clear communication helps manage expectations and can prevent stakeholder surprises down the road. Flagging potential tax issues up front builds trust and can avoid costly renegotiations.

- *Consider seeking a formal tax opinion, insurance or even an IRS ruling.* For complex or high-risk transactions, these measures provide an extra layer of certainty and protection for everyone involved. Do not hesitate to bring in tax advisors early, as collaboration is the key to successful outcomes.

Inversion Risk: Make It a Priority

Inversion risk is not just a tax advisor’s problem; it can fundamentally alter the economics of a restructuring, jeopardize creditor recoveries and threaten a plan’s feasibility. Bankruptcy does not immunize transactions from tax scrutiny, particularly with respect to inversions. Once an inversion has been triggered, the consequences are often severe and irreversible, making it extremely difficult to unwind or cure the restructuring transactions.

For bankruptcy professionals, understanding and proactively managing inversion risk is essential. Involving tax advisors early in the process can protect clients and ensure successful outcomes. **abi**

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⁹ Redomiciling a foreign entity to another foreign jurisdiction may have foreign tax consequences that are beyond the scope of this article.