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Tax Alert

IRS Issues More Rules Affecting Inversions

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On September 23, the IRS issued long-promised rules intended to discourage U.S. companies from being acquired by foreign companies in so-called "inversion" transactions, which are policed by Section 7874 of the Internal Revenue Code. In Notice 2014-52, the IRS has taken steps to increase the number of transactions treated as an inversion, and to make the tax consequences of certain post-inversion transactions less attractive from a U.S. tax perspective.

These new rules are generally stated to be effective for inversion transactions completed on or after September 22. The Notice did not tighten the so-called earnings stripping rules, which limit interest deductions for U.S. companies on debt owed to foreign affiliates. However, the Notice indicated that future changes to the earnings stripping rules applicable to post-inversion interest deductions would be retroactive to September 22.

I. Background

Under Section 7874, an inversion occurs if substantially all of the properties of a domestic corporation (which can include its stock), are acquired by a foreign corporation and either:

(a) the former owners of the domestic corporation own 60% or more of the foreign acquiring corporation by reason of having held domestic corporation stock (the "ownership fraction"); and

(b) the corporate group that includes the foreign acquirer corporation (the expanded affiliated group, or "EAG," in the language of the regulations) does not have substantial business activities in the jurisdiction in which the foreign acquiring corporation is incorporated.

The ownership fraction takes into account all former owners of the domestic corporation, not just U.S. shareholders. **If the ownership fraction is 80% or more, then the foreign acquiring corporation is treated as a domestic corporation for U.S. federal income tax purposes.** Thus, an inversion that meets the 80% ownership fraction has accomplished nothing from a U.S. tax perspective.

Existing regulations implementing the substantial business activities test make it very difficult for any multinational corporation to satisfy them. That leaves transactions in which the former shareholders of the U.S. target hold less than 80% of the foreign acquirer after the transaction as the focus of most recent inversion transactions.

II. Creating more inversions

The IRS previously issued guidance which in many cases disregards certain stock issued by the foreign acquiring corporation in determining the ownership fraction. For example, stock issued by the foreign acquirer in an IPO or private placement related to the acquisition does not count in determining the ownership fraction. The Notice adds three new rules to determine the ownership fraction:

- Anti-Stuffing Rules. The IRS has been concerned about inversions completed by using a “cash box” foreign acquirer. To address this, the new rules provide that if more than 50% of the assets held by foreign members of the EAG consist of cash or similar assets, then a corresponding percentage of the shares of the foreign corporation’s stock is not taken into account in the ownership fraction. When this occurs, the ownership fraction increases, making an 80% inversion more likely.
- Anti-Skinny Down Rules. The IRS will disregard certain distributions by the domestic target made in the 36-month period prior to the inversion to the extent they exceed 110% of the average distributions in the preceding three years. This will increase the ownership fraction, making an 80% inversion more likely.
- “Spinversions” and Other Transfers of Stock. Under the Notice, transfers of foreign acquiror stock by corporate shareholders to persons outside of the EAG may result in an 80% inversion in cases where one would not otherwise occur. Certain exceptions are provided for transfers within the existing EAG.

III. Preventing some forms of post-inversion planning to reduce U.S. tax

The Notice contains several rules to prevent tax reduction planning by inverted companies:

- Anti-Hopscotch Rules. Loans by an existing foreign subsidiary of the U.S. target (a “CFC”) to a newly affiliated foreign company during a ten-year post-inversion period will be treated as a deemed dividend to the U.S. parent. The same rule will apply to an acquisition of stock in such an affiliate by that CFC.
- Anti-CFC Decontrol Rules. The Notice contains complex rules to prevent the de-controlling of the CFCs of the U.S. target, which taxpayers have attempted to do in order to reduce future U.S. tax on the extraction of the deferred earnings of their CFCs. The general effect of the new rules will be to impose current tax on those deferred earnings in the case of a decontrol transaction.
- Other Changes. The Notice makes changes to other rules that limit the foreign acquirer’s ability to engage in transactions which could remove earnings from the domestic target’s CFCs without the imposition of U.S. tax.

IV. Conclusion

The Notice takes a significant step in eliminating the many tax benefits that could be derived from post-inversion transactions with the U.S. company’s new foreign affiliates. It does not, however, address earnings stripping transactions. It remains to be seen if these changes are sufficient to diminish the current inversion wave that has attracted so much attention.

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