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New Rules on Inversion Transactions

November 22, 2015

On November 19 the Treasury Department announced new rules for inversion transactions when it issued Notice 2015-79 (the "Notice").

The Notice has four categories of changes:

- changes that make it more difficult for US companies to invert;
- changes that reduce the tax benefits of inversions;
- changes that facilitate transactions by insurance companies; and
- technical changes and clarifications to existing rules.

By far the most important new rule is that the common parent of the foreign and US companies following the inversion must have the same tax residence as the foreign company unless the shareholders of the US company receive less than 60% of the common parent's stock in the inversion.

The Notice does <u>not</u> propose any new rules about "earnings stripping". The Notice reiterated, however, that Treasury and the IRS are continuing to consider guidance on earnings stripping and other base erosion techniques. Treasury officials have separately indicated that such guidance is likely in the next several months.

CHANGES THAT MAKE IT MORE DIFFICULT FOR US COMPANIES TO INVERT

For an inversion to be successful (1) the shareholders of the US company must receive less than 80% of the resulting company (the "80% Test") or (2) the foreign acquiring company must have "substantial business activities" in the foreign jurisdiction in which it is incorporated (the "Substantial Business Test"). If the 80% Test (but not the Substantial Business Test) is satisfied, then post-inversion restrictions apply if shareholders of the US company receive 60% or more of the resulting company. No restrictions apply if those shareholders receive less than 60% of the resulting company.

"Third Country Rule" for Inversions Under the 80% Test.

In many inversions a new foreign holding company ("New Topco") acquires both the US company and the foreign target corporation ("Foreign Target"). New Topco is often tax resident in a different foreign country than Foreign Target.

The Notice stops this practice by providing that if New Topco and Foreign Target are tax residents of different countries, then the New Topco shares issued to the shareholders of Foreign Target will not be taken into account in determining whether the 80% Test is met. The effect is to generally make it impossible to satisfy the 80% Test; as a result, this "Third Country Rule" means that the tax jurisdiction of New Topco will virtually always have to be the same as the jurisdiction of tax residence of Foreign Target, unless the shareholders of the US company receive less than 60% of the stock of the combined company.

Note that this Third Country Rule cannot be avoided by having Foreign Target change its tax residence (either by reincorporating or moving its management) to the desired jurisdiction of New Topco before the inversion and as part of the same plan as the inversion.

Note also that this Third Country Rule does not prevent New Topco from being tax resident in a different jurisdiction than its jurisdiction of incorporation. This Third Country Rule is focused only on tax residency; so long as New Topco and Foreign Target are tax resident in the same jurisdiction, this Third Country Rule will not apply.

This Third Country Rule for inversions under the 80% Test applies to inversions completed on or after November 19, 2015.

"Third Country Rule" for Inversions Under the Substantial Business Test.

The Substantial Business Test is difficult to meet and few, if any, recent public inversions have sought to meet it. It requires that 25% of the assets, income and employees of the inverted group be located in the country where the resulting foreign parent company is incorporated. Before the Notice, the foreign parent company could be tax resident in a different jurisdiction than its jurisdiction of incorporation. The Notice changes this by providing that the Substantial Business Test cannot be met unless the resulting company is a tax resident of the same foreign country in which it is incorporated.

This Third Country Rule for inversions under the Substantial Business Test applies to inversions completed on or after November 19, 2015.

Clarification of Anti-Stuffing Rule for Inversions Under the 80% Test.

Existing rules prevent "stuffing" certain assets into Foreign Target in order to make Foreign Target larger, which, in turn, would make it easier to satisfy the 80% Test. On their face, the anti-stuffing rules apply to transfers to Foreign Target of liquid assets, like cash and marketable securities, and to any other property transferred with a principal purpose of avoiding the inversion rules. Some taxpayers have taken the position that the anti-stuffing rules applied to transfers to Foreign Target of non-liquid assets (such as stock of a private company) only if the transaction was an indirect transfer to Foreign Target of liquid assets (such as cash or marketable securities owned by the transferred private company).

The Notice makes clear that the anti-stuffing rules apply to any property transferred to Foreign Target with a principal purpose of avoiding the purposes of the inversion rules and are not limited to direct or indirect transfers of liquid assets.

This clarification applies to inversions completed on or after November 19, 2015.

CHANGES THAT REDUCE THE TAX BENEFITS OF INVERSIONS

Changes to Definition of Inversion Gain.

Existing rules provide that the inverted US company is taxed on any "inversion gain" it realizes during the ten-year period after the inversion. "Inversion gain" is, generally, gain arising from transfer or license of property by the US company to a related foreign company. Inversion gain cannot be sheltered by tax attributes of the US company, such as net operating losses or tax credits.

Under existing rules inversion gain does not include gain resulting from the indirect transfer of property out from under the US company where the US company is not taxed directly on that gain. For example, if a foreign subsidiary of the US company transfers assets to a related foreign corporation, any resulting income flowing up indirectly to the US company (i.e., "subpart F income") would not be inversion gain and thus could be sheltered by the US company's NOLs, tax credits or other tax attributes.

The Notice expands the definition of inversion gain to include income of the US company attributable to transfers or licenses of property out from under the US company if the transfers are either part of the inversion or made to a related foreign person after the inversion. A similar, new rule will apply to indirect transfers made through partnerships.

This expanded definition of inversion gain is retroactive; it applies to inversions completed on or after September 22, 2014.

Increase in Gain Recognized on CFC Stock.

After an inversion, the US company can move its controlled foreign corporations ("CFCs") out from under the US company in a manner that is normally tax-free. This results in the CFCs ceasing to be CFCs. Existing rules provide that such a transfer to a related foreign corporation results in gain recognition by the US company, but the gain is limited to the amount of the CFC's "earnings and profits".

The Notice changes this rule so that the full amount of the gain is recognized on such a transfer, even if the gain exceeds the CFC's "earnings and profits".

This rule is retroactive; it applies to inversions completed on or after September 22, 2014.

CHANGES THAT FACILITATE TRANSACTIONS BY INSURANCE COMPANIES

Under existing "cash box" rules, it was difficult or impossible to meet the 80% Test if the acquiring foreign corporation's assets were comprised principally of cash, marketable securities or other liquid assets. An exception was provided for banks, because banks hold liquid assets in the ordinary course of business. Insurance companies also hold liquid assets in the ordinary course of business, but the corresponding exception for insurance companies was so narrow that it almost never applied.

The Notice expands the exception from the cash box rule for insurance companies to apply to a broader set of insurance companies. However, Treasury and the IRS are still concerned about insurance companies holding excessive passive assets in relation to the insurance risks assumed and expect to issue separate guidance concerning such companies.

This change applies to inversions completed on or after November 19, 2015, but taxpayers may elect to apply this new rule to inversions completed before November 19, 2015.

TECHNICAL CHANGES AND CLARIFICATIONS TO EXISTING RULES

Non-Ordinary Course Distributions.

Under existing rules, the value of any "non-ordinary course distributions" made by the US company in the three years preceding the inversion were added back to the US company's value for purposes of applying the inversion rules, including determining whether the 80% Test is met. Determining the amount of "non-ordinary course distributions" requires a complex computation, but the existing rules are intended to police "skinny-down" tactics that are intended to make the US company smaller and thus increase the likelihood that the 80% Test or other inversion requirements will be met.

The Notice excludes from the addback rule transactions in which the shareholders of the US company own less than 5% (by vote and value) of the inverted group after completion of the transaction. The effect of this rule is to make sure transactions for all (or mostly) cash are not inadvertently treated as transactions that fail the 80% Test or other inversion requirements. This new rule will not apply if the distributions were in fact made to avoid the purposes of the inversion rules.

This change applies to inversions completed on or after November 19, 2015, but taxpayers may elect to apply this new rule to inversions completed before November 19, 2015.

Dilution of CFCs after Inversions.

Under existing rules, if a CFC of an inverted US company has its stock transferred (including by issuance of new shares) to a related foreign person, the transaction will be recharacterized in a manner that is adverse to the US company. An exception to the existing recharacterization rules applies if the value of the US company's stake in the CFC does not decrease by more than 10%.

Certain taxpayers interpreted this exception as applying when the value of the US company's stake in the CFC did not decrease by 10% rather than when the US company's percentage ownership (by value) in the CFC did not decrease by 10%. The Notice clarified this exception by making clear that the proper focus is on the US company's percentage ownership (by value) in the CFC.

This rule applies to transfers (including by issuance) of CFC stock completed on or after November 19, 2015, but only if the applicable inversion was completed on or after September 22, 2014.

CONCLUSION

With the exception of the Third Country Rule under the 80% Test, the changes in the Notice are either incremental or merely clarifying existing rules. Most notably, existing "earnings stripping" techniques remain unaffected by the Notice, and taxpayers will have to wait longer to see what administrative action, if any, Treasury takes to limit such techniques. If any future earnings stripping guidance applies only to inverted groups, that guidance may apply retroactively to inversions completed on or after September 22, 2014.

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