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Hunt for Inversions

By Robert W. Wood • Wood LLP

The IRS is after inversions. So are some members of Congress. So are some political candidates, notably Hillary Clinton. And the public may not like them either, which during election season may matter.

Amid this hubbub, the IRS released Notice 2015-79 [IRB 2015-49, 775], which foreshadows regulations designed to further cut back on these transactions. Inversions are transactions in which domestic corporations are acquired by foreign ones. Of course, in many cases, it is the American company that is on the hunt for a likely foreign partner.

The goal, as everyone knows, is for the over-taxed and out-competed American company to improve the jurisdiction of its big tax obligations, reducing its all-important effective tax rate. The tax code already contains rules to thwart such transactions, but they are clearly insufficient to do so in the current climate. Code Sec. 367 contains rules to make inversions more expensive at the shareholder level.

Code Sec. 7874 has its focus on corporate-level consequences. Code Sec. 7874 applies to a foreign corporation that makes a direct or indirect acquisition of substantially all of the properties directly or indirectly held by a domestic corporation if:

- immediately after the acquisition, the former shareholders of the domestic target have a certain level of continued ownership (by vote or value) in the foreign acquiring buyer; and
- the expanded affiliated group of the foreign buyer does not have substantial business activities in the foreign acquiring buyer's country of organization as compared to the worldwide business activities of the expanded affiliated group.

If the former domestic company's shareholders own 80 percent or more of the company when the smoke clears, Code Sec. 7874 treats the foreign acquiring buyer as domestic for all purposes. In short, the "let's shift our corporate headquarters to Ireland" ruse will not work. Nevertheless, the 80-percent line is important.

If the former domestic company's shareholders own at least 60 percent but less than 80 percent of the foreign company post-transaction, the

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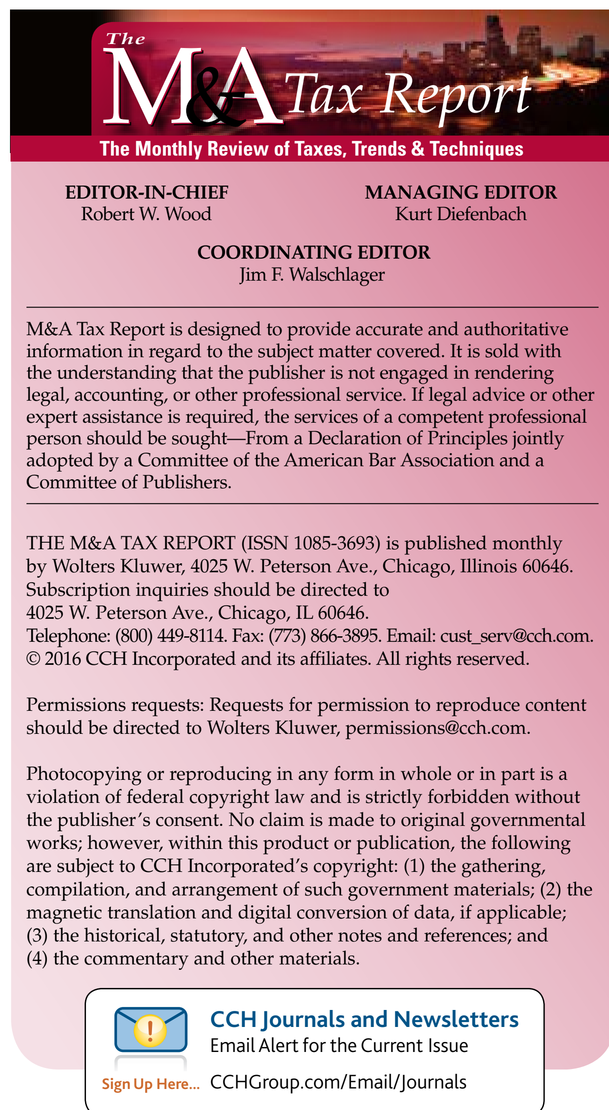
foreign buyer will be respected as a foreign corporation for U.S. tax purposes. That means the inversion will succeed at least in part. However, the U.S. target and certain of its related U.S. persons will be treated as expatriated entities.

The impact of this taint is important. It will mean that the company will face limitations on its use of losses and other U.S. tax attributes with respect to income or gain recognized on certain property transfers and licenses during the inversion. What's more, this limitation will remain in effect for a 10-year period following the acquisition.

Of course, the pace of deal closings and announcements suggests that Code Sec. 7874 does not go far enough in discouraging these transactions. And that is where the IRS comes in with its interpretive and regulatory powers. In 2014, the IRS issued Notice 2014-52 [2014-42 IRB 712] (the "2014 Notice") to stem the tide.



2014 Notice provides rules that disregard a portion of the foreign acquiring company's stock if there is too much "foreign group nonqualified property." Since there have been some complaints, Notice 2015-79 modifies the 2014 Notice to make the rules easier on active insurance businesses.

60 Percent to 80 Percent

If the ownership percentage is at least 60 percent but less than 80 percent, then the domestic target and certain related U.S. persons will face limitations on their ability to reduce the U.S. tax imposed on their inversion gain. This inversion gain is generally defined as the income or gain recognized by reason of a transfer or license of property by an expatriated entity as part of the inversion. However, inversion gain also includes income or gain on a transfer or license of property (other than inventory) by an expatriated entity to certain related foreign persons during the 10 years following the inversion.

Notice 2015-79 expands the scope of the inversion gain to include income or gain recognized on certain indirect property transfers or licenses. Exactly what type of property transfer or license is covered is going to be the subject of guidance. It also seems likely to be the subject of disputes.

Taxed at Home?

The IRS's newest anti-inversion missive, Notice 2015-79, targets foreign buyers that are not even subject to tax in the pertinent foreign country as a resident. The Notice is clear that the company may well have substantial business activities and a substantial business presence there. However, if it is not *taxable* there as a *resident* of that foreign country, those substantial business activities will not count.

As the Notice puts it, "the policy underlying the exception to section 7874 when there are substantial business activities in the relevant foreign country is premised on the foreign acquiring corporation being subject to tax as a resident of the relevant foreign country."

Third-Country Transactions

Notice 2015-79 also attacks what it calls "third-country transactions." This involves a domestic entity that combines with an existing foreign

corporation, but *via* establishing a new foreign parent corporation for the combined group with a tax residence that is different from that of the existing foreign corporation. In effect, the parent corporation of the combined group will be a tax resident of a third country.

This provision effectively prevents the substantial business activities test from being satisfied when the foreign acquiring company is not a tax resident for local-country purposes. This rule makes the tax nexus of the foreign buyer with its own country of organization important. In some cases, of course, this rule may go too far. For example, one can argue that there is no abuse if the expanded affiliated group of the foreign buyer is subject to local country tax. The corporate residence of the foreign parent arguably should not matter.

Post-Inversion Planning

One can argue over whether it is the inversion itself that should be targeted or what the inverted company does thereafter that should really be scrutinized. The latter is at least as important, if not more so. A transaction may be respected, and yet the IRS may still want to restrict the extent to which U.S. tax benefits such as net operating losses or foreign tax credits can be used.

The IRS is concerned that a decision to locate the tax residence of the new foreign parent is generally driven by tax planning, including U.S. tax avoidance after the acquisition. For example, the third country may have a more favorable income tax treaty than the country of the currently existing foreign parent. Consequently, Notice 2015-79 concludes that "a third-country parent typically is chosen to facilitate the use of low- or no-taxed entities to erode the U.S. tax base following the acquisition."

To address these transactions, the IRS says that it will disregard certain stock of a foreign acquiring corporation that is issued to the shareholders of the existing foreign corporation for purposes of determining whether the 80-percent threshold is met. This rule will apply to acquisitions that satisfy a four-part test identified in the Notice:

1. The foreign buyer directly or indirectly acquires substantially all of the properties directly or indirectly held by a foreign target. This determination will be made using standards similar to those that currently apply in determining whether foreign buyer has directly or indirectly acquired substantially all of the properties directly or indirectly held by a domestic target.
2. The gross value of all property directly or indirectly acquired by foreign buyer exceeds 60 percent of the gross value of all "foreign group property" other than "foreign group nonqualified property" as determined under the 2014 Notice, as modified by Notice 2015-79. The relevant property for these purposes generally is the foreign buyer's pre-inversion property other than certain passive assets and property acquired by foreign buyer for purposes of avoiding the application of Code Sec. 7874 to the inversion.
3. The foreign buyer is a tax resident of a different country than the foreign target, as determined before the purchase and any related transaction (including a relocation of the foreign target's management or control).
4. The ownership percentage would otherwise be at least 60 percent (but less than 80 percent).

If all four requirements are met, the regulations will provide that the foreign acquiring stock will be excluded from the ownership test.

Notice 2015-79 also addresses post-inversion tax avoidance transactions. In inversion transactions, Code Sec. 7874(a)(1) requires that the "taxable income of an 'expatriated entity' for any taxable year that includes any portion of the 'applicable period' be no less than the 'inversion gain' of the entity for the taxable year." In effect, Code Sec. 7874(a)(1), along with Code Sec. 7874(e)(1), is designed to ensure that an expatriated entity generally pays current U.S. tax with respect to inversion gain.

Certain indirect transfers of stock or other property by an expatriated entity, however, will also be scrutinized. The IRS says that such transfers may have the effect of removing foreign operations from U.S. taxing jurisdiction while avoiding current U.S. tax. The IRS says that regulations will provide that inversion gain includes:

> income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as an expatriated entity's

section 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property, either: (i) as part of the acquisition; or (ii) after such acquisition if the transfer or license is to a specified related person.

The Notice also mentions certain exchanges of stock of an expatriated foreign subsidiary. The IRS's concern appears to be that certain nonrecognition transactions that dilute a U.S. shareholder's ownership of an expatriated foreign subsidiary may allow the U.S. shareholder to avoid U.S. tax on unrealized appreciation in property held by the expatriated foreign subsidiary at the time of the exchange. The intended regulations will address this concern by requiring "the exchanging shareholder to recognize all of the gain in the stock of the expatriated foreign subsidiary that is exchanged, without regard to the amount of the expatriated foreign subsidiary's undistributed earnings and profits."