Inversion Transactions Revisited

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Now that the dust has settled on the American Jobs Creation Act of 2004 ("the Jobs Act"), we should look anew at corporate inversion transactions. The idea of an inversion, of course, is for a U.S. corporation to reincorporate in a foreign jurisdiction, thereby replacing the U.S. parent corporation of a multinational corporate group with a foreign parent.

Broad Brush

For some time before the Jobs Act, Congress was searching for an appropriate vehicle to stop domestic public companies from reincorporating overseas. The new vehicle for doing so is Code Sec. 7874, added by Section 801(a) of the Jobs Act. It is quite complex, and defines an inversion transaction broadly. In essence, the new law will treat the foreign company that results from the inversion as a domestic company or, alternatively, will treat the gain arising from the inversion transaction as fully taxable. Although the new Code section is replete with definitions, it is not yet clear (to me at least) whether it entirely fixes the area.

Inversion transactions take many different forms, including stock inversions, asset inversions and various combinations and variations of the two. Perhaps the most classic kind of transaction is a stock inversion, in which a U.S. corporation typically forms a foreign subsidiary, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then will merge into the U.S. corporation, with the U.S. corporation surviving. This makes the U.S. company now a subsidiary of the new foreign company. The U.S. corporation's shareholders will receive shares of the foreign corporation in a tax-free swap.

Asset inversions are designed to reach a similar result. However, they generally are accomplished through a direct merger of a top-tier U.S. corporation into a new foreign corporation.

Related Transactions

Apart from the paradigm inversion transaction, there is some corporate clean-up restructuring that often occurs. As one example, in an effort to remove income from foreign operations from the reach of U.S. taxation, the U.S. corporation will often transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation (or other related foreign corporations). Likewise, the corporate group may want to take advantage of the inversion by reducing U.S. tax on U.S. source income through earnings stripping or other transactions.

These transactions can be complicated, far more complicated than the inversion itself. They may include earnings stripping through payment by the U.S. corporation of deductible amounts, such as interest, rents, royalties and management service fees, such amounts generally being paid to a foreign affiliate. There is a body of learning about all of this, generally derived from the multinational corporate group which has a foreign parent and U.S. subsidiaries.

Closing the Barn Door?

After a great deal of publicity, inversion transactions are less popular today than they were a few years ago. Under new Code Sec. 7874, such transactions may give rise to immediate U.S. tax consequences at the corporate and/or shareholder level.

In a stock inversion, U.S. shareholders have to recognize gain (but do not get to recognize loss) based on the difference between the fair market value of the foreign corporation shares they receive and the adjusted basis of the domestic corporation stock they exchange. If a company's value has declined, or it has many foreign or even tax-exempt shareholders, this tax cost to the shareholder is reduced or even eliminated.

An inversion transaction can also result in U.S. tax consequences at the corporate level where there is a transfer of foreign subsidiaries or other assets to the foreign parent. The tax on any income recognized as a result of this kind of restructuring can be reduced or eliminated through the use of NOLs, foreign tax credits and other tax attributes.

In asset inversion transactions, the U.S. corporation will generally have to recognize gain (but not loss) under Code Sec. 367 as if it had sold all of its assets. The shareholders, however, generally will not have to recognize gain or loss, assuming that the transaction meets the reorganization requirements.

New Era

Adding to the deep recesses of the Code, the Jobs Act added Code Sec. 7874. It defines two different types of inversions, establishing a different set of tax consequences for each type.

The first category of inversions is a transaction in which, pursuant to a plan or series of related transactions, all of the following occur:

- A U.S. corporation becomes a subsidiary of a foreign incorporated entity, or otherwise transfers substantially all of its properties to one, and the transaction is completed after March 4, 2003.
- The former shareholders of the U.S. corporation hold 80 percent or more (by vote or value) of the stock of the foreign incorporated entity after the transaction (as a result of holding stock in the U.S. corporation).
- The foreign incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership, does not have substantial business activities in the entity's own country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.

"Expanded Affiliated Groups"

This new "expanded affiliated group" concept uses a 50-percent ownership standard rather than 80 percent, seeking to broaden the affiliation net. If the transaction meets the three requirements, the new Code provision denies the intended tax benefits of such an inversion. It does so by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code. However, since the top-tier foreign entity is treated for all purposes as domestic, the shareholder toll charge that would generally be applied to an inversion under Code Sec. 367 does not apply to this inversion.

There are rules disregarding certain ownership. Stock sold in a public offering related to the transaction is disregarded. Similarly, in determining whether a transaction meets the definition of an inversion under the new Code provision, stock that is held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. If a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded.

Properties or liabilities that are transferred as part of a plan, a principle purpose of which is to avoid the purposes of the new Code section, are also disregarded. The Treasury also is granted express authority to prevent avoidance of this anti-inversion rule, including avoidance through the use of related persons, passthrough or other noncorporate entities, or other intermediaries. Likewise, regulations may be issued to prevent avoidance of the anti-inversion rule through transactions designed to either qualify or disqualify a person as a related person or member of an expanded affiliated group. This regulatory authority extends to treat certain nonstock instruments as stock, and certain stock as not constituting stock, where necessary to carry out this new anti-inversion system.

Transactions Between 60 and 80 Percent

The second type of inversion transaction identified by Code Sec. 7874 is one which would meet the definition described above, *except* that the transaction does not meet the 80-percent ownership threshold. If at least 60 percent ownership is met, a second set of rules applies. Here, the inversion transaction will be respected. However, there's a catch.

Any applicable corporate level toll charges for establishing the inversion structure will not be offset by tax attributes (NOLs, foreign tax credits, *etc.*). That means any applicable corporate-level income or gain that is required to be recognized on the transfer of controlled foreign corporation stock (or the transfer or license of other assets by a U.S. corporation as part of the inversion or after that transaction to a related foreign person) is taxable. Plus, the tax attributes that one customarily relies upon to mitigate such a tax will not be available.

Again, there is a timing threshold. A transaction that otherwise meets the definition of an inversion transaction will not be treated as one if, on or before March 4, 2003, the foreign incorporated entity had *already* acquired (directly or indirectly) more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business.

Special Rules

Some partnership transactions are brought within the reach of the anti-inversion provision too. The benefits of an inversion are denied where a foreign incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership if, after the acquisition, at least 60 percent of the stock of the entity is held by former partners of the partnership. As one would expect, the basic definition of an inversion must also be met. However, this concept of including partnership transactions is a sophisticated one. For purposes of applying this rule, all partnerships that are under common control within the meaning of Code Sec. 482 are treated as one.