Wolters Kluwer

The M&A Tax Report

May 2016 Volume 24, Number 10

The Monthly Review of Taxes, Trends & Techniques

Inversions, Panama and Keyser Söze

By Robert W. Wood • Wood LLP

Inversions have been in the news a lot for the last few years. In an inversion, a company moves its tax residence overseas—ostensibly to avoid U.S. taxes—without making significant changes to its business operations. The transaction can be as simple as the U.S. company creating a foreign subsidiary in a low-tax jurisdiction and then merging into it. More commonly, however, the transaction is structured so that the U.S. company ends up as a wholly owned subsidiary of the new foreign company. The U.S. company and its foreign subsidiary simply trade places on the org chart—hence the term "inversion."

All this corporate juggling happens only on paper. The U.S. company continues to conduct its domestic operations in the United States and to direct its foreign operations from its U.S. headquarters. Corporate officers and directors may make a few ritual visits to the low-tax country where the new foreign parent company is organized, but that's about as far as it goes. So the inverted U.S. company continues to take advantage of all the benefits of being located in the United States while potentially reducing the taxes it pays to the U.S. government.

Inversions are controversial, because one company's tax savings can end up shifting a greater tax burden to other U.S. businesses, and even to American families. It makes for bad press. It can read like a corporate version of the Panama Papers. Laudably, the U.S. government wants cross-border transactions to be driven by genuine business strategies.

Conversely, the government wants to thwart gambits to shift tax residence to a low-tax jurisdiction to avoid U.S. taxes. The IRS and the Treasury have taken several big-batted swings at inversions. Congress also swung once in 2004.

Since that swing was not too successful, there has been talk that Congress would return to the plate. But now, with the April 2016 putsch by the Treasury, Congress seems let off the hook entirely. Well, unless Congress wants to tackle actual tax reform, that is.

That could happen, but now it seems a long way away. On April 4, 2016, the Treasury and the IRS released temporary and proposed regulations to block the most egregious inversions, which do little more than provide a U.S. company with an overseas mailing address, and to cut back on earnings stripping. Substantial foreign corporations will continue to acquire U.S. companies, as witness the announcement on April 21 that Tyco International PLC (which left the U.S. almost 20 years ago) and Milwaukee-based Johnson Controls, Inc., are moving ahead with their planned merger, which has a substantial tax motivation. But "off-the-shelf" inversions seem dead, not unlike Scrooge's former partner, Jacob Marley. Dead as a doornail.

The new rules are complex but limit inversions by disregarding foreign parent stock attributable to recent inversions or acquisitions of U.S. companies. That makes it more likely than an inversion will trigger adverse tax consequences under existing U.S. law. And the impact, past, present and future, already seems palpable. Pfizer, Inc., and Allergan PLC called off their planned $160 billion merger just two days after the new inversion regulations were announced. The deal was expected to lower Pfizer's tax rate from perhaps 24 to 17 percent, or thereabouts, and would not have been treated as an inversion under prior U.S. law. But Allergan is what's known as a "serial inverter"—it has grown rapidly in recent years by acquiring a series of U.S. companies. Under the new rules, Allergan's history would have been enough to subject the merger to the U.S. anti-inversion regime. So the deal cratered. (Interestingly, the stock market did not take the news too hard. Pfizer's share price actually increased by seven percent in the first few days after it walked away from the merger.)

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Barbara Mittel

EDITORIAL ASSISTANT
Raghavendra Kaup

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Party like It's 2004

Congress added Code Sec. 7874 to the tax code in 2004. In general, if three conditions are met, Code Sec. 7874 prevents the use of certain tax attributes to reduce the U.S. federal income tax owed on the income or gain recognized in transactions intended to remove foreign operations from the U.S. taxing jurisdiction. In more extreme cases, Code Sec. 7874 treats the new foreign parent corporation as a domestic corporation for all purposes of the Code. That, of course, defeats the whole point of the transaction.

These rules have turned out to be ineffective as U.S. corporations and their advisors have figured out ways to invert without triggering Code Sec. 7874. But let us review them before we move to the 2016 regulations, which are the Treasury's latest attempt to put the 2004 rules into practice. Code Sec. 7874 applies if:

1. the foreign acquiring corporation completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (domestic entity acquisition);
2. after the domestic entity acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation (former domestic entity shareholders) by reason of holding stock in the domestic corporation (this percentage is referred to here as the "ownership percentage," and, the fraction used to calculate the ownership percentage is referred to as the "ownership fraction"); and
3. after the domestic entity acquisition, the expanded affiliated group (or EAG) as defined in Code Sec. 7874(c)(1) does not have

substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized (relevant foreign country), when compared to the total business activities of the EAG.

In cases where these requirements are met, but the former shareholders of the domestic corporation end up owning 80 percent or more of the stock of the foreign acquiring corporation, Code Sec. 7874 treats the foreign acquiring corporation as a domestic corporation fully subject to U.S. tax.

Excise Tax

It is important to keep this Code Sec. 7874 framework in mind as we move forward. But in addition to adding Code Sec. 7874 in 2004, Congress also added Code Sec. 4985 at that time. The latter imposes an excise tax on Section 16(a) officers and directors of an inverting corporation.

The tax is 15 percent of the covered officer or director's stock-based compensation, including options, held from six months before to six months after the inversion. Congress knew that the taxes on an inversion would be triggered to shareholders under Code Sec. 367. But the very people who generally recommended an inversion in the first place—the officers and directors—often avoided the taxes by holding options.

The Code Sec. 4985 excise tax was designed so these persons, like rank-and-file shareholders, would be hit with a 15-percent tax. It was the counterpart of the then 15-percent capital gain tax. However, it became common for companies to gross up their officers and directors for the Code Sec. 4985 excise tax, which eliminated much of its *in terrorem* effect.

2014 and 2015 Notices

In September 2014 and November 2015, the Treasury issued rules to make it more difficult for companies to benefit from inversions. In 2014, it was Notice 2014-52 [2014-42 IRB 712]. The 2014 Notice said that there would soon be regulations issued to address transactions structured to avoid the purposes of Code Sec. 7874 and Reg. §1.367(a)-3(c), and certain post-inversion tax avoidance transactions.

Next, in November 2015, IRS issued Notice 2015-79 [2015-49 IRB 775]. It announced that there would be rules issued to address additional transactions. In the crosshairs would be deals structured to avoid the purposes of Code Sec. 7874 and Reg. §1.367(a)-3(c). Certain additional post-inversion tax avoidance transactions would be scrutinized too.

2016 Temporary Regulations

Now, in April 2016, the IRS has gone truly big, with a Barry Bonds-sized swing at the head of inversions. The 2016 temporary regulations include modified rules drawn from the 2014 and 2015 Notices. They can be heavy going.

In addition, the 2016 rules tell one how to identify domestic entity acquisitions and foreign acquiring corporations in certain multiple-step transactions. They also explain how to calculate the ownership percentage. One must disregard certain stock of the foreign acquiring corporation in determining the denominator of the ownership fraction. The smaller the denominator, the greater the chances that a transaction will hit the 60-percent or 80-percent triggers.

The rules undo the effect of certain nonordinary course distributions (NOCDs) made by a domestic entity that would otherwise reduce the numerator of the ownership fraction. The rules even help to determine when certain stock of a foreign acquiring corporation is treated as held by a member of the EAG. They also try to determine when an EAG has substantial business activities in the relevant foreign country.

There is, needless to say, quite a lot here. The temporary regulations provide a rule that treats a subsequent acquisition as a domestic entity acquisition, and the subsequent acquiring corporation as a foreign acquiring corporation. If pursuant to the same plan or series of related transactions a foreign corporation acquires substantially all of the properties held by a subsequent acquiring corporation, a multiple-step acquisition rule applies.

This means that the further acquisition is treated as a domestic entity acquisition. The foreign corporation that made the acquisition is treated as a foreign acquiring corporation. The multiple-step acquisition rule applies in a similar manner when the domestic entity is a domestic partnership.

Owning Up

In general, disqualified stock is not included in the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the domestic entity) in exchange for nonqualified property. Nonqualified property includes cash or cash equivalents and marketable securities. So the foreign acquiring corporation can't buff up its stock value by simply loading up on non-operating assets.

Nonqualified property also includes certain obligations, including obligations owed by members of the EAG. It also includes any other property acquired in a transaction or series of transactions related to the domestic entity acquisition with a principal purpose of avoiding Code Sec. 7874.

Passive Assets

The passive asset rule dates to the 2014 Notice. Under it, the stock of a foreign acquiring corporation attributable to certain passive assets is excluded from the denominator of the ownership fraction. However, this is only if, after the domestic entity acquisition and all related transactions are complete, more than 50 percent of the gross value of all foreign group property constitutes certain passive assets.

There is a *de minimis* exception to the passive asset rule if two requirements are satisfied. The ownership percentage must be less than five percent, by vote and value. But this is determined without regard to the application of the passive assets rule as well as the NOCDs rule discussed below.

Furthermore, on the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete (the completion date), former domestic entity shareholders or former domestic entity partners in the aggregate must own less than five percent (by vote and value) of the stock of (or the partnership interests in) each member of the EAG. Notably, though, when applying this less-than-five-percent limitation, one must use the attribution rules of Code Sec. 318(a) with the modifications described in Code Sec. 304(c)(3)(B).

Serial Inversions

This brings us to the rule that killed the Pfizer-Allergan merger. For purposes of calculating the ownership percentage by value with respect to a domestic entity acquisition (the relevant domestic entity acquisition), one must exclude from the denominator of the ownership fraction any stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions. This multiple domestic entity acquisition rule applies if, within the 36-month period ending on the signing date (in general, subject to an anti-avoidance rule, the first date on which the contract to effect the relevant domestic entity acquisition is binding) with respect to the relevant domestic entity acquisition, the foreign acquiring corporation (or a predecessor) completed one or more other domestic entity acquisitions that are not excluded under an exception (each such other domestic entity acquisition, a prior domestic entity acquisition).

Usually, a domestic entity acquisition is excluded from the definition of a prior domestic entity acquisition if the ownership percentage with respect to such domestic entity acquisition was less than five percent, and if the fair market value of the by-reason-of stock received by the former domestic entity shareholders (or former domestic entity partners) did not exceed $50 million.

Third-Country Rule

The third-country rule dates from the 2015 Notice. Under it, stock of the foreign acquiring corporation held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation will be excluded from the denominator of the ownership fraction. The new rules replace the gross value requirement of the 2015 Notice with a continuity of interest requirement.

In general, it is satisfied if at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation. Nevertheless, stock of the foreign acquiring corporation held by former domestic entity shareholders (or former domestic entity partners) is not taken into account.

The temporary regulations generally retain the domestic entity ownership and tax residency requirements as described in the 2015 Notice. However, they clarify that the tax residency of the foreign acquiring corporation is determined after the covered foreign acquisition and all related transactions. A covered foreign acquisition is generally defined as a transaction in which there is an acquisition of substantially all of the properties of a foreign corporation in which the foreign ownership percentage is at least 60 percent. In addition, the tax residency of the acquired foreign corporation is determined before the covered foreign acquisition and all related transactions.

Nonordinary Course Distributions

The NOCDs rule dates to the 2014 Notice. Under it, certain distributions made by a domestic entity before being acquired by a foreign acquiring corporation that otherwise would reduce the numerator of the ownership fraction are disregarded. NOCDs are defined as the excess of all distributions made during a tax year by the domestic entity with respect to its stock or partnership interests over 110 percent of the average of such distributions during the 36-month period immediately preceding such tax year.

For purposes of determining the ownership percentage by value, former domestic entity shareholders or former domestic entity partners are deemed to receive, by reason of holding stock or an interest in the domestic entity, an amount of stock of the foreign acquiring corporation with a fair market value equal to the aggregate value of NOCDs made by the domestic entity (NOCD stock). Thus, the NOCDs rule does not apply for purposes of determining the ownership percentage by vote.

The rules provide that the amount of a distribution (including with respect to property distributed in redemption of stock) is determined based on the value of the property distributed at the time of the distribution. Accordingly, post-distribution fluctuations in the value of the stock or interests of the domestic entity, or the value of the distributed property, should not affect the amount of NOCD stock deemed received.

Expanded Affiliated Group Rules

To prevent Code Sec. 7874 from applying to certain transactions that do not give rise to inversion policy concerns, Code Sec. 7874(c)(2)(A) provides that stock of a foreign acquiring corporation that is held by members of the EAG is not included in the numerator or the denominator of the ownership fraction (the statutory EAG rule). Still, this rule may not always lead to appropriate results, such as when the domestic entity has minority shareholders.

To address these cases, the rules provide two exceptions to the statutory EAG rule. First, there is an internal group restructuring exception. Then, there is a loss-of-control exception. Finally, there is the statutory EAG rule. Together, they are referred to as the EAG rules.

When either of these exceptions applies, stock of the foreign acquiring corporation held by members of the EAG is excluded from the numerator. But it is not eliminated from the denominator. In general, the internal group restructuring exception applies when the domestic entity and the foreign acquiring corporation are members of an affiliated group with the same common parent both before and after the acquisition.

Generally, this is based on an 80-percent vote-and-value requirement. The loss-of-control exception applies when the former domestic entity shareholders or former domestic entity partners do not hold more than 50 percent of the stock of any member of the EAG after the acquisition.

Subject to Tax

The subject-to-tax rule dates to the 2015 Notice. Under it, an EAG cannot have substantial business activities in the relevant foreign country when compared to the EAG's total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country. An EAG is considered to have substantial business activities in the relevant foreign country only if at least 25 percent of its group employees, group assets and group income are located or derived in the relevant foreign country.

The 2016 regulations clarify that financial reporting principles are only relevant for determining the amount of items of income that are taken into account. An EAG must take into account all items that its members recognized for financial accounting purposes during the testing period.

Post-Inversion Tax Avoidance

An inversion installs a new foreign parent corporation as the head of the inverted group. But the group will still principally consist of domestic corporations (U.S. shareholders) and their controlled foreign corporations (CFCs). These CFCs will often be holding significant undistributed profits. Paying dividends to their U.S. shareholders will be no more attractive after the inversion than it was before, because the dividend will still be taxable to the U.S. shareholder. Consequently, a major tax goal of the foreign parent corporation following an inversion is to gain access to these profits without paying dividends. In a domestic context, Code Sec. 956 tries to prevent CFCs from making loans to related parties or devising other dividend substitutes by imposing tax consequences when a CFC invests in "U.S. property" as defined in Code Sec. 956(c)(1). The new rules extend this approach to deal with inverted groups by declaring, solely for purposes of Code Sec. 956, that any obligation or stock of a non-CFC foreign-related person is U.S. property within the meaning of Code Sec. 956(c)(1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period.

U.S. property generally includes an obligation of a foreign person and stock of a foreign corporation if: (1) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary; (2) the foreign person or foreign corporation is a non-CFC foreign-related person; and (3) the obligation or stock was acquired either during the applicable period or in a transaction related to the inversion transaction.

A non-CFC foreign-related person is defined as a foreign-related person that is not itself an expatriated foreign subsidiary. The rule applies to obligations and stock acquired during the applicable period or in a transaction related to the inversion transaction. This is generally so regardless of whether the obligation or stock would constitute U.S. property.

However, stock or obligations that otherwise meet the requirements of the U.S. property rule but that were issued prior to the applicable period, in a transaction related to the inversion transaction, constitute U.S. property, provided they are acquired on or after April 4, 2016.

Earnings Stripping

After a corporate inversion, multinationals often use earnings stripping to minimize U.S. taxes, by paying deductible interest to their new foreign parent or one of its foreign affiliates in a low-tax country. The Treasury/IRS answer is to target transactions that generate large interest deductions by increasing related-party debt without financing new U.S. investment. The IRS can now divide instruments into part debt and part equity.

In addition, some large corporations are required to do up-front due diligence and documentation concerning characterization of related-party financial instruments as debt. Failing to adhere to these requirements means that instruments will be treated as equity.

Effective Date

In general, the rules that date to the 2014 Notice are effective on or after September 22, 2014. The rules that date to the 2015 Notice apply to acquisitions completed on or after November 19, 2015. However, a new rule on the application of Code Sec. 304(b)(5) is a generally applicable rule that applies without regard to whether there was an inversion transaction.

The new rules included in the temporary regulations, including any changes to rules described in the 2014 and 2015 Notices, generally apply to acquisitions or post-inversion tax avoidance transactions completed on or after April 4, 2016. The new rule that reduces post-inversion tax benefits (by requiring a CFC to recognize all realized gain upon certain Code Sec. 351 transfers) applies only if the inversion transaction was completed on or after September 22, 2014.

Regulations Withdrawn In Part

The IRS has partially withdrawn portions of two sets of proposed regulations issued in 2009 and 2014. The withdrawn portion of the 2009 proposed regulations no longer reflects current law, and the withdrawn portion of the 2014 proposed regulations has been amended.

Some foreign companies may avoid Code Sec. 7874's existing curbs on inversions by acquiring multiple American companies in relatively short order. The value of the foreign company increases to the extent it issues its stock in connection with each successive acquisition. That would enable the foreign company to complete another, potentially larger, acquisition of an American company to which Code Sec. 7874 would ostensibly not apply.

Over a relatively short period of time, a significant portion of a foreign acquirer's size may be attributable to the assets of these recently acquired American companies. It would be inconsistent with Code Sec. 7874 to allow a foreign company (including a recent inverter) to increase in size to avoid these rules. Thus, in computing ownership percentages, the new rules exclude stock of the foreign company attributable to assets acquired from an American company within the three-year period before the signing date of the latest acquisitions.

Transactions Related-Party Debt Not Financing New U.S. Investment

After an inversion, a U.S. subsidiary may issue its own debt to its foreign parent as a dividend. The foreign parent may then transfer this debt to a low-tax foreign affiliate. The idea is to have the U.S. subsidiary deduct the interest on its tax return even though the foreign affiliate reports it at a far lower tax rate somewhere else, if tax is even paid on the interest at all.

As a result, the new rules treat as stock an instrument that might otherwise be considered debt if it is issued by a subsidiary to its foreign parent in a shareholder dividend distribution. The rules also address a similar two-step version of a dividend distribution of debt, in which a U.S. subsidiary borrows cash from a related company and then pays a cash dividend distribution to its foreign parent.

The new rules also treat as stock an instrument that might otherwise be considered debt if it is issued in connection with certain acquisitions of stock or assets from related corporations in transactions that are economically similar to a dividend distribution. Nonetheless, the proposed regulations should leave undisturbed related-party debt that is incurred to fund actual business investment. That means debt to build or equip a factory should not be reclassified.

Furthermore, the proposed regulations generally apply to debt issued between related corporations that are members of groups with more than $50 million of intercompany debt that otherwise would be treated as stock under the regulations. There is, however, a general anti-abuse rule for structured transactions involving unrelated persons.

Allowing IRS to Split Debt into Debt and Equity

An all-or-nothing debt versus equity approach can be unworkable. Sometimes, the facts support treating debt partially as debt and partially as stock. The new rules give the IRS this explicit authority.

Requiring Information for Debt-Equity Analysis

The IRS sometimes has trouble gathering sufficient data to conduct a debt-equity analysis. The new rules now say companies are required to complete documentation up front to establish that a financial instrument is really debt. The proposed regulations require that key information be documented.

This includes a binding obligation of the issuer to repay the principal amount borrowed, creditor's rights, a reasonable expectation of repayment and evidence of ongoing debtor-creditor relationship. If these requirements are not met, instruments will be characterized as equity for tax purposes.

Then, There Is Congress

President Obama and his Treasury Secretary have been criticized in some circles for taking what amounts to legislative action on inversions. And some of the voices have come from the legislative branch itself. Perhaps the problem of inversions should be addressed through legislation.

House Ways and Means Committee Chairman Kevin Brady, R-Texas, stated in an April 4, 2016, press release that although he was "pleased that President Obama acknowledged how our broken tax code continues to hurt our economy, it's clear that his new regulations won't solve the problem. Americans will continue to watch their jobs move overseas until Washington works together on comprehensive, pro-growth tax reform."

Senate Finance Committee Chairman Orrin Hatch, R-Utah, likewise commented that "[t]he administration continues to tinker along the regulatory edges with unilateral proposals to address the symptoms of inversions, but not the disease. … A comprehensive tax overhaul that reduces the rate, transitions to a territorial tax system with base erosion protections, and addresses earnings stripping will equip American businesses with the certainty they need to invest in a future here at home."

On April 18, a group of 18 former Treasury officials wrote to Treasury Secretary Jacob Lew urging reconsideration of the proposed and temporary inversion regulations. The former officials, who mostly served during Republican administrations, include George Schultz, who was President Nixon's Treasury Secretary for a time and is evidently still taking an active interest in tax policy at age 95. Like the Republican members of Congress, the former officials expressed concern that issuance of the anti-inversion regulations "bypasses the legislative process." Picking up on another GOP theme, they contend that corporate inversions are a "symptom" of a deeper problem—the "disease" that is the United States' system of worldwide taxation. They argue that trillions of dollars of profits have been "stranded" overseas because of U.S. tax policy and that this is depriving the United States of capital for productive investment. They also point out that U.S. corporate income tax rates, at least on paper, are higher than in the average OECD rate of 25 percent. Their proposed solution is to make fundamental changes to the U.S. tax system, not to add regulations to block tax-motivated inversions.

Will Congress finally act on tax reform? Only time will tell, but sometimes these invocations of high principle sound a bit like the proverbial order to round up the usual suspects. In the meantime, if reading the latest on the Treasury's battle against abusive inversions is too taxing, the short version may be that they are dead.

Article Submission Policy

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodLLP.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

Wolters Kluwer

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH