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Tax Alert

Treasury, IRS Issue Guidance Regarding Inversions and Related Transactions

On September 22, 2014, the US Treasury (Treasury) and the Internal Revenue Service (IRS) issued Notice 2014-52, 2014-42 IRB (Notice 2014-52), which describes regulations to be issued by the Treasury and the IRS intended to reduce the tax benefits of, and limit the ability of companies to engage in, corporate "inversion" transactions.

Background

A corporate "inversion" generally refers to a transaction pursuant to which a US parent corporation of a multinational corporate group reincorporates in a non-US jurisdiction or restructures itself such that the US parent corporation is replaced by a corporation organized in a non-US jurisdiction. A principal reason to engage in a corporate inversion is to reduce the effective income tax rate on income earned from non-US sources.

In 2004, in order to combat lost tax revenue resulting from corporate inversions, the United States enacted legislation under section 7874 of the Internal Revenue Code of 1986, as amended (the Code), to limit the ability of a US parent corporation to effect an inversion transaction. Section 7874 of the Code targeted transactions pursuant to which: (i) substantially all of the properties held directly or indirectly by a US parent corporation are acquired by a new non-US parent corporation; (ii) after the acquisition, at least 60 percent of the new non-US parent corporation stock is owned by former shareholders of the US parent corporation by reason of such shareholders' prior ownership of the US parent corporation; and (iii) the new non-US parent corporation does not, directly or indirectly, carry on "substantial business activities" in the new non-US parent corporation's jurisdiction.[1]

Specifically, section 7874 of the Code provides that if, following a corporate inversion, the former shareholders of the US parent corporation own: (i) at least 60 percent but less than 80 percent of the new non-US parent corporation, the new non-US parent corporation's ability to use its US tax attributes to offset certain US income will be limited; or (ii) at least 80 percent of the new non-US parent corporation, the new non-US parent corporation will be treated as a US corporation for all US tax purposes.[2]

Recently, there has been a flurry of corporate inversions effected by means of mergers with non-US partners. These transactions have not triggered the above-described anti-inversion rules, primarily because they did not result in 80 percent (or 60 percent with respect to the limitation of use of certain US tax benefits) of the stock of the new non-US parent corporations being owned by former shareholders of the inverting US parent corporations.

In reaction to these inversions, legislation (including, for example, an existing proposal to reduce to 50 percent the 80 percent ownership threshold referred to above) has been introduced in Congress. However, although this or a similar proposal likely would be included in any comprehensive tax reform, based on the current political climate, any such reform appears unlikely until, at the earliest, after the mid-term elections later this year.

In the absence of Congressional action, there has been a big push for the current administration to reduce the tax benefits of corporate inversions, and, therefore, the administration has been looking carefully at alternatives that may be available under executive and regulatory authority, including, possibly, measures with retroactive effect.

Consistent therewith, on September 22, 2014, the Treasury and the IRS issued Notice 2014-52, which Treasury Secretary Jacob Lew referred to as the "first targeted steps" intended to make it more difficult for US corporations to reduce their US tax bills by way of a corporate inversion.

Notice 2014-52

Notice 2014-52 describes regulations, generally applicable to corporate inversion transactions completed on or after September 22, 2014, to be issued by the Treasury and the IRS to reduce the tax benefits of, and limit the ability of companies to engage in, corporate inversions. The regulations to be issued will: (i) expand the scope of the existing anti-inversion legislation by addressing transactions that are structured to avoid the purposes of section 7874 of the Code;

[1] The anti-inversion rules can also apply to the direct or indirect acquisition by a foreign corporation of substantially all of the properties constituting the trade or business of a US partnership.

[2] As noted above, even if the 60 percent ownership test is met, the anti-inversion rules of section 7874 of the Code will not be triggered if the new non-US parent corporation carries on, directly or indirectly, "substantial business activities" in its jurisdiction (i.e., at least 25 percent of its employees, 25 percent of its assets and 25 percent of its income must be located in or derived from such jurisdiction).

and (ii) prevent a new non-US parent corporation from accessing, on a tax-free basis, the earnings of any pre-inversion “controlled foreign corporations” or “CFCs” of the former US parent corporation.

Specifically, the regulations will provide as follows:

- A loan from a CFC to the new non-US parent corporation made during the 10-year period beginning on the date of the inversion generally will be treated as “US property” for purposes of section 956 of the Code, giving rise to a potential deemed dividend inclusion as if the CFC had made a loan to the US parent corporation prior to the inversion.
- Attempts to de-control CFCs by having the new non-US parent corporation acquire a sufficient amount of stock of a CFC during the 10-year period beginning on the date of the inversion will be addressed by recharacterizing the transaction in such a manner as to prevent the CFC from becoming de-controlled, and ensuring that the deferred earnings and profits of the CFC continue to be subject to US tax.
- A loophole under section 304 of the Code that allows the new non-US parent corporation to sell its stock in the former US parent corporation to a CFC with deferred earnings in exchange for cash or property of the CFC, resulting in a tax-free repatriation of cash or property of the CFC, will be eliminated.
- The 80 percent inversion threshold will be strengthened by:
  - Limiting the ability of a non-US parent corporation from inflating its size for purposes of the 80 percent inversion threshold by disregarding certain passive assets that are not part of the corporation’s daily business functions, if at least 50 percent of the non-US parent corporation’s assets are passive assets, such as cash or marketable securities (i.e., “cash boxes”);
  - Limiting the ability of a US corporation to reduce its size for purposes of the 80 percent inversion threshold by disregarding “non-ordinary course distributions” occurring during the 36-month period ending on the date of the inversion; and
  - Eliminating a loophole that previously allowed a US corporation to engage in a so-called “spinversion” transaction (generally, a US corporation drops a portion of its assets into a new non-US corporation and distributes the non-US corporation to its shareholders) by taking advantage of an exception to the inversion rules intended to apply to certain internal restructurings.

Conclusion

The anti-inversion guidance contained in Notice 2014-52 should still permit properly structured corporate inversions motivated by non-tax business purposes to be effected, and for such inversions to serve as a vehicle for allowing multinational US-headquartered corporations to set up a pipeline for future growth outside of the US tax net. It does, however, serve as a clear indication to multinational US-headquartered corporations that the administration will continue to use its administrative and regulatory authority to stem the flood of corporate inversions. In particular, Notice 2014-52 leaves the door open for future administrative guidance to address two common strategies of inverted corporations—the use of debt issued by the inverted US corporation to a non-US affiliate to generate US interest deductions or the use of intercompany transactions to otherwise strip out US earnings free of US tax. A potential next step in the administration's approach to limiting benefits now available to US corporations following an inversion would be, for example, to issue regulations (possibly with retroactive effect, at least with respect to groups that complete inversion transactions on or after September 22, 2014) that would recharacterize related party debt as equity, thereby transforming an otherwise deductible interest payment into a nondeductible dividend, or otherwise to expand the scope of the "earnings-stripping" rules under section 163(j) of the Code.

Accordingly, because corporate inversions may continue to be attractive to certain US-headquartered multinational corporations, such corporations will need to consider carefully Notice 2014-52, and any potential future pronouncements—as well as, of course, any anti-inversion legislation included in future comprehensive tax reform—when evaluating the pros and cons of engaging in such a transaction.

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