# New U.S. Treasury Regulations Implement Inversion Rules, Take Aim at "Serial Inverters" and Earnings Stripping

On April 4, 2016, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued proposed and temporary regulations (the "Inversion Regulations") addressing so-called inversion transactions. In general, the Inversion Regulations:

- Adopt, with certain modifications, the rules described in Notice 2014-52 (the "First Notice") and Notice 2015-79 (the "Second Notice");[1] and
- Add a new (and unexpected) rule aimed at so-called (by the Treasury) "serial inverters."

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Simultaneous with the issuance of the Inversion Regulations, the Treasury and the IRS also proposed sweeping new regulations under Code Section 385 that, if finalized in their current form, would, in many cases, limit the tax benefits available to acquired U.S. corporations from so-called "earnings stripping" transactions (the "Debt/Equity Regulations").[2] However, in a move that surprised many tax practitioners, the proposed Debt/Equity Regulations are not limited to inverted U.S. corporations, but instead apply broadly to almost all multinational groups with a U.S. presence. These proposed regulations are discussed in detail in a separate *Kirkland Alert*, but their specific impact on inversion transactions is briefly discussed below.[3]

These two sets of regulations make inversion transactions (and their tax benefits) more difficult to achieve in certain situations. However, it is important to emphasize that, even under these new rules, a U.S. corporation can still structure a successful inversion transaction with the right set of facts. Indeed, in the press release accompanying the Inversion Regulations, Secretary Lew reiterated that only Congress can shut down inversion transactions completely. Unless such actions are taken (or until Congress addresses the underlying systemic issues that cause U.S. corporations to become non-U.S. parented corporations in the first place) we expect that U.S. corporations will continue to consider inversion transactions.

## A. Background

As a general matter, Code Section 7874 applies ownership tests in determining whether a transaction is treated as an inversion transaction for the purposes of the provision and the consequences of such treatment. These ownership tests are designed to measure the percentage of the foreign acquirer owned by the former shareholders of the U.S. corporation as a result of an inversion transaction. Where the "ownership percentage" (i.e., the percentage of the foreign acquirer owned by

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former shareholders of the U.S. corporation) equals 60% or more (by vote or value), a number of adverse tax rules apply to the group, but the foreign acquirer is respected as a foreign corporation for U.S. federal income tax purposes. Where the "ownership percentage" is 80% or more (by vote or value), the foreign acquirer is treated as a U.S. corporation for U.S. federal income tax purposes, thus defeating any tax planning objectives of the transaction.

**B. The New Multiple Acquisitions Rule (The "Serial Inverter" Rule)**

By far, the most important new rule included in the Inversion Regulations is the "multiple acquisitions" rule aimed at discouraging foreign acquirors that have previously acquired one or more U.S. corporations in inversion transactions from engaging in further inversion transactions. Treasury has labelled such foreign corporations as "serial inverters" because the value of the foreign corporation increases after each successive inversion transaction, thus allowing the foreign corporation to subsequently acquire a larger U.S. corporation.[4]

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Prior to the promulgation of the Inversion Regulations, most practitioners properly believed that multiple, independent acquisitions by a foreign corporation would not be tested together, for purposes of the ownership fraction, because such transactions were not pursuant to a plan (or series of related transactions). However, in the preamble to the Inversion Regulations, the IRS took the questionable position that, in certain cases, the inversion rules should not permit a foreign corporation to reduce the ownership percentage by virtue of recent acquisitions of U.S. corporations, even if there was no demonstrable plan to undertake the subsequent transaction at the time the first transaction was completed.

To implement this policy, the Inversion Regulations adopt a surprising new rule that excludes from the denominator of the ownership fraction (for purposes of measuring value but not vote) any stock that was issued as consideration to shareholders of an acquired U.S. corporation within the 36 month period ending on the *signing* date of the inversion transaction. However, an acquisition of a U.S. corporation is not subject to this rule if (1) the former shareholders of the U.S. corporation own less than 5% of the foreign acquirer after the inversion transaction (by vote and value) and (2) the fair market stock of the stock of the foreign acquirer received by the former shareholders of the U.S. corporation did not exceed $50 million. Thus, an all-cash acquisition of a U.S. corporation is exempt from this rule no matter how large the acquisition is.[5]

The Inversion Regulations also include an anti-abuse rule that prevents the parties from delaying the signing date for purposes of the multiple acquisitions rule by terminating an initial agreement, and then subsequently entering into a second agreement after the 36-month period has expired with respect to a substantially similar transaction (if a principal purpose of the arrangement is to avoid the inversion rules).

**C. Changes to the Rules Contained in the First Notice and Second Notice**

The Inversion Regulations adopt, with modifications, the rules outlined in the First Notice and the Second Notice that were discussed in our prior client alerts. Certain of the key modifications to these rules are briefly discussed below.

*The Non-Ordinary Course Distribution ("NOCD") Rule (or "Anti-Skinny Down" Rule).* As contemplated by the First Notice, the NOCD rule applies to add back certain distributions made by the acquired U.S. corporation for purposes of calculating the ownership percentage, even when such distributions are wholly unrelated to the acquisition. The Inversion Regulations adopt three important modifications to the proposed NOCD rule of the First Notice. First, the Inversion Regulations clarify that the amount of a distribution is determined based on the value of the property on the date of the distribution (thus appreciation or depreciation in the property between the distribution date and the date of the acquisition is ignored).

Second, the Inversion Regulations helpfully clarify that the add-back of NOCDs only applies for purposes of measuring the value, and not the voting power, of the acquired U.S. corporation.

Third, the Inversion Regulations provide a new and surprising rule for distributions pursuant to Code Section 355 (i.e., tax free spin-offs). In situations where the fair market value of the stock of the controlled corporation exceeds the fair market value of the stock of the distributing corporation (ignoring the value of the controlled corporation) immediately before the spin-off, the controlled corporation will be deemed, on the date of the spin-off and solely for purposes of the NOCD rule, to have distributed the stock of the distributing corporation (i.e., the direction of the spin-off is reversed). The amount of the deemed distribution is equal the value of the distributing corporation, but excludes the value of the controlled corporation. This rule applies regardless of whether the direction of the spin-off was driven solely by non-tax business or legal considerations.[6] Unfortunately, the Inversion Regulations do not explicitly state that when this rule applies, the distributing corporation will be deemed *not* to have distributed the stock of the controlled corporation for purposes of the NOCD rule.

*The Cash Box Rule.* As contemplated by the First Notice, the "cash box" rule generally disregards a portion of the shares of a foreign acquiring corporation in determining the ownership percentage if 50% of the gross value of all property held by the foreign acquiring corporation and its group members consists of cash or other passive assets. The Inversion Regulations introduce 2 helpful exceptions to the cash box rule. First, where an acquisition involves *de minimis* ownership of the foreign acquirer by former shareholders of the U.S. corporation (generally 5% or less of the foreign acquirer), the cash box rule will not apply. Second, in determining the amount of cash or other passive assets held by group members of the foreign acquirer, the Inversion Regulations exclude assets held by a group member that is not owned directly or indirectly by the foreign acquirer. This second exception might apply, for example, where the foreign acquiring corporation is itself a subsidiary of a parent entity that holds substantial sums of cash and passive assets.

*United States Property Rule (Curtailing "Hopscotch Loans").* The First Notice in-

cluded rules attacking the use of so-called "hopscotch loans," in which a cash-rich controlled foreign subsidiary of an acquired U.S. corporation loans funds to the foreign acquirer after an inversion transaction (thereby "hopping over" the acquired U.S. corporation). The First Notice reduced the tax benefits associated with hopscotch loans by, in certain circumstances, treating the loans as investments in "United States property" that result in deemed dividends to the acquired U.S. corporation under Code Section 956. The Inversion Regulations provide that certain exceptions from the definition of "United States property" will apply to hopscotch loans (including exceptions relating to obligations arising out of the sale or processing of property, or that arise in connection with the provision of services). However, the Inversion Regulations also provide that the short term obligation exception included in Notice 88-108 will *not* apply to hopscotch loans (i.e., the exception for obligations that are collected within 30 days, as long as the controlled foreign corporation does not have loans that would constitute United States property outstanding during the year for 60 or more days).

**Even under the Debt/Equity Regulations, it may still be possible for the U.S. group to increase its leverage in connection with, or subsequent to, an inversion transaction, to the extent cash is either being used to fund U.S. operations or is being provided as consideration to the shareholders of the U.S. corporation in the transaction.**

### D. Earnings Stripping

Under current law, one of the primary tax benefits from an inversion transaction can be increasing the leverage on the U.S. group which results in potentially valuable interest deductions. Typically, the incremental leverage is held by a low or no tax foreign affiliate. In many cases, the leverage is created by having the U.S. group (or a newly formed U.S. parent of the U.S. group) either (1) distribute a note to its foreign parent after the acquistion or (2) acquire shares in the foreign parent in exchange for a note, which shares are then delivered to the U.S. corporation's shareholders as consideration in the acquisition. As discussed in more detail in the separate *Kirkland Alert*, the leverage created through the techniques described above will generally be re-characterized as equity under the proposed Debt/Equity Regulations, with the result that interest deductions would no longer be available (among other consequences). However, even under the Debt/Equity Regulations, it may still be possible for the U.S. group to increase its leverage in connection with, or subsequent to, an inversion transaction, to the extent cash is either being used to fund U.S. operations or is being provided as consideration to the shareholders of the U.S. corporation in the transaction.[7]

### E. U.S. Model Treaty Changes Aimed at Reducing the Benefits of an Inversion Transaction

Apart from the Inversion Regulations and Debt/Equity Regulations discussed above, the Treasury launched a separate attack on inversion transactions when it released its revised 2016 U.S. Model Income Tax Convention (the "2016 Model") on February 17, 2016. The 2016 Model includes new provisions (not included in any existing bilateral tax treaty) that would reduce the benefits of an inversion transaction by denying treaty benefits for U.S. withholding taxes on U.S. source dividends, interest, royalties and guarantee fees paid by an "expatriated entity" to certain "connected" foreign parties during the 10-year period following completion of an inversion transaction. If these new provisions are widely adopted in the U.S. tax treaty network, it could further limit the benefits of "earnings stripping" transactions by

subjecting interest payments on internal leverage to a 30% U.S. withholding tax. The preamble to the 2016 Model states that the term "expatriated entity" has the meaning given to such term under Code Section 7874(a)(2)(A) as of the date the relevant bilateral tax treaty is signed. Under current law, this generally means a U.S. corporation that has undertaken an inversion transaction in which the ownership percentage is equal to or greater than 60% but less than 80%. The 2016 Model also provides that, for purposes of the relevant treaty, the term "expatriated entity" will not be affected by legislative amendments to Code Section 7874 that are enacted after the treaty's signing date.

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As of now, these new treaty provisions are only contained in the 2016 Model Treaty and have not yet been included in any bilateral tax treaty. As such, the new rules would only become effective once specific treaties are renegotiated and then ratified by the Senate and the competent authority of the applicable foreign country.

### F. Effective Dates

The new rules included in the Inversion Regulations (including the new "serial inverter" rule), and the modifications to the rules outlined in the First Notice and Second Notice, are generally effective for transaction closing on or after April 4, 2016. However, the rules originally announced in the First Notice are generally effective for transactions completed on or after September 22, 2014, and the rules originally announced in the Second Notice are generally effective for transactions completed on or after November 19, 2015.

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1 The *Kirkland Alert* discussing the First Notice is available here and the *Kirkland Alert* discussing the Second Notice is available here.

2 References to the "Code" are to the Internal Revenue Code of 1986, as amended.

3 The *Kirkland Alert* discussing the Debt/Equity Regulations is available here.

4 Consider the following example: Assuming all-stock 60/40 deals, an old and cold foreign corporation worth $1MM can acquire a U.S. corporation worth $1.5MM. The combined corporation ($2.5MM) could then acquire a U.S.corporation worth $3.75MM. That combined corporation ($6.25MM) could then acquire a U.S. corporation worth $9.375MM. And so on.

5 Importantly, the new rules do not represent an all-out ban on inversion transactions taking place within 36 months of one another. For example, if foreign corporation had an equity value of $110MM, it could successfully engage in an all-stock transaction with a U.S. corporation with an equity value of $400MM because the former shareholders of the U.S. corporation would own approximately 78.4% of the combined entity (i.e., 400MM ÷ (110MM + 400MM)). This rule does not prevent the foreign corporation from acquiring another U.S. corporation with an equity value of $400MM during the 36-month period following the original acquisition in an unrelated transaction.

6 In other words, the parties do not need to have a tax avoidance motive for choosing the direction of the spin-off, and under the general NOCD rule the spin-off can be completely unrelated to the subsequent acquisition transaction.

7 In addition, if the intercompany leverage arises in a manner that is not recharacterized under the Debt/Equity Regulations on issuance, it still may later be recharacterized under the "Funding Rule" discussed in further detail in this *Kirkland Alert*.

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