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U.S. Treasury and Internal Revenue Service Issue New Anti-Inversion Guidance

The Second Notice expands upon and in certain instances modifies prior guidance from the First Notice, but also adds a few new surprising hurdles of its own.

Over the past several years, a number of high-profile transactions have been effectuated or proposed in which a U.S. corporation is technically acquired by a smaller foreign corporation in order to, in part, achieve a more efficient tax-profile for the U.S. corporation on a going forward basis (commonly referred to as an "inversion transaction"). The wave of such inversion transactions has led to considerable debate in the press, Congress, and the Obama administration about whether (and how) to curtail the proliferation of such transactions.

On September 22, 2014, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") responded by issuing Notice 2014-52 (the "First Notice"), which was designed to restrict the ability of taxpayers to engage in inversion transactions and to limit the benefits of such transactions once completed. While the First Notice curtailed the pace of inversion transactions (and even led to the termination of several signed deals), inversion transactions have nonetheless continued to occur. Indeed, on November 23, 2015, Pfizer Inc. announced its combination with Allergan PLC in the largest inversion transaction ever announced.

On November 19, 2015, the Treasury and the IRS launched their latest attack on inversion transactions by issuing Notice 2015-79 (the "Second Notice"). The Second Notice expands upon and in certain instances modifies prior guidance from the First Notice, but also adds a few new surprising hurdles of its own.

As discussed in more detail below, the Second Notice describes regulations that the Treasury intends to issue that will further limit the ability of U.S. corporations to engage in and benefit from inversion transactions by:

- Restricting the ability of a U.S. corporation to combine with a foreign target in a "third country" jurisdiction;
- Clarifying that certain "anti-stuffing" rules (designed to prevent the artificial inflation of the size of the foreign acquiring corporation) can apply to the contribution of active business assets (rather than only passive investment assets) to the foreign acquiring corporation if such contribution has "a principal purpose" of avoiding the anti-inversion rules; and
- Adding a new requirement to the "substantial business activities" exception in which the foreign acquiring corporation must be tax resident (and not merely organized) in the jurisdiction in which the substantial business activities occur.

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The Second Notice also describes new rules that will (i) make post-inversion "out from under" planning more difficult to achieve and (ii) provide limited (and pro-taxpayer) modifications to certain rules described in the First Notice.

These changes will have a significant impact in certain situations, but they do not yet get to the core of the issue that motivates inversion transactions. As a result, we would expect that U.S. corporations will continue to consider (and indeed implement) inversion transactions. Indeed, the Treasury has repeatedly stated that it believes that only Congress can take actions that will actually prevent inversions, and as of now, it is unclear whether Congress has any interest in taking such actions.

One of the most surprising aspects of the Second Notice is that it does not include any new guidance on so-called "earnings stripping" transactions. However, because Treasury has stated that any such guidance will be retroactive, taxpayers remain on notice that the benefits of earnings stripping may ultimately be restricted for previously consummated transactions.

A. No Guidance on Earnings Stripping

One of the most surprising aspects of the Second Notice is that it does *not* include any new guidance on so-called "earnings stripping" transactions. In the First Notice, the Treasury expressed a concern that inverted U.S. corporations may, in certain cases, be avoiding U.S. tax by shifting or "stripping" its U.S.-source earnings to lower-tax jurisdictions through the use of tax-deductible interest payments on intercompany debt. The Treasury also stated that it may (after further study) issue regulations to address such strategies and that any such regulations will generally apply retroactively to groups that completed inversion transactions on or after September 22, 2014.

The Treasury reiterated, in the Second Notice, that it continues to study the issue and that future guidance (if and when issued) may be retroactive to groups that completed inversion transactions on or after September 22, 2014. The lack of earnings stripping guidance in the Second Notice presumably reflects the challenges Treasury faces in addressing the issue in the context of inversion transactions in light of the very specific rules governing earnings stripping in Section 163(j) of the Internal Revenue Code and the comprehensive body of law governing debt/equity determinations. However, because Treasury has stated that any such guidance will be retroactive, taxpayers remain on notice that the benefits of earnings stripping may ultimately be restricted for previously consummated transactions.

B. New Rules to Limit Inversion Transactions

1. No Third-Country Foreign Parent

A major change set forth in the Second Notice relates to "third-country" transactions, in which a U.S. corporation and a foreign corporation combine into a newly-formed foreign acquiring parent corporation, which has a different tax residence than the combining foreign corporation. For example, this rule would limit the ability of a U.S. corporation and Canadian or Irish corporation to combine into or under a newly-formed U.K. holding company.

Citing concerns that the choice of a holding company jurisdiction is largely driven by tax planning and a desire to erode the U.S. tax base,[1] the rules described in the

Second Notice provide that, for purposes of the 60% and 80% ownership tests,[2] any stock issued by the foreign acquiring corporation to the shareholders of the acquired foreign corporation is disregarded when each of the following four requirements is satisfied:

1. The foreign acquiring corporation acquires substantially all of the properties held directly or indirectly by the acquired foreign corporation.

2. The gross value of all property acquired from the foreign corporation exceeds 60% of the gross value of the foreign group property owned by the foreign acquiring corporation after the inversion transaction (disregarding certain assets, such as passive assets and assets held by the U.S. corporation's subsidiaries).[3]

3. The tax residence of the foreign acquiring corporation is not the same as the tax residence of the acquired foreign corporation, as determined before the inversion transaction and taking into account any related transactions.

4. The ownership percentage (prior to taking into account these rules) (i.e., percentage of stock owned by former shareholders of the U.S. corporation) is at least 60% but less than 80%.

Importantly, this new rule does not apply where the former shareholders of the acquired U.S. corporation own less than 60% of the foreign acquiring corporation after the transaction.

Importantly, this new rule does *not* apply where the former shareholders of the acquired U.S. corporation own less than 60% of the foreign acquiring corporation after the transaction.[4] In this case, the foreign acquiring corporation can be tax resident in any foreign country, without regard to the tax residence of the acquired foreign corporation.

To date, a significant number of inversion transactions have used a foreign acquiring corporation that is tax resident in one of the UK, Ireland, or the Netherlands, even though the acquired foreign corporation was formed in, and was a tax resident of, a different foreign jurisdiction (e.g., Canada). Each of those jurisdictions has a favorable tax regime for holding companies and, as a result, the Treasury appears to have made the considerable leap that tax was the sole or primary driver for choosing those jurisdictions. However, each of those jurisdictions also has significant non-tax advantages, including stable economies, predictable legal systems, flexible corporate laws, and strong intellectual property protections. As a result, non-tax factors also play a significant role in the decision of multinational groups as to where to locate their headquarters. Nevertheless, the rules described above do not include any exception where there is a significant (or primary) non-tax business purpose for re-incorporating in a third country, including due to changed circumstances or future growth prospects.

2. *Clarification of the "Anti-Stuffing" Rules*

The current regulations include an anti-stuffing rule pursuant to which stock issued by the foreign acquiring corporation in exchange for "nonqualified property" is disregarded for purposes of the 60% and 80% ownership tests. These rules are gener-

ally designed to prevent taxpayers from "stuffing" an acquired foreign corporation with passive assets in order to fit within the relevant ownership thresholds.

In the Second Notice, the IRS expressed a concern that certain taxpayers are narrowly interpreting the anti-stuffing rule to the effect that it only applies to the contribution of passive or highly liquid assets (or stock in entities that own passive or highly liquid assets). The rules described in the Second Notice will "clarify" that the anti-stuffing rules can apply to *any* property, even business assets, acquired with a principal purpose of avoiding the anti-inversion rules.

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The Second Notice does not provide any guidance regarding when the foreign acquiring corporation will be deemed to acquire business assets with "a principal purpose" of avoiding the anti-inversion rules. Presumably, the new rules are not intended to capture the direct or indirect acquisition of business assets that will be used by the foreign acquiring corporation in its trade or business, as is the case in so-called "spinversion transactions" (as opposed to situations where the foreign acquiring corporation has no business reason for making such acquisition or otherwise has a plan to dispose of such business assets shortly after the acquisition). However, the Second Notice did not make this point clear and the relevant example included in the Second Notice summarily concludes that the "business assets" transferred to the foreign acquiring corporation were acquired with a principal purpose of avoiding the purposes of the anti-inversion rules, without any elaboration.

We would hope that the final regulations will clarify that the anti-stuffing rule will not apply to the transfer of business assets that will be used in the foreign acquiring corporation's trade or business, notwithstanding that such asset acquisition facilitates the acquisition of the U.S. corporation by the foreign acquiring corporation in a transaction that does not run afoul of the anti-inversion rules.

3. Substantial Business Activities – New Tax Residence Requirement

Under pre-existing law, the anti-inversion rules do not apply to a transaction where the foreign acquiring corporation has "substantial business activities" in its jurisdiction of formation. Under the applicable regulations, an entity generally has substantial business activities in a jurisdiction if at least 25% of its assets, employees, and income are located in that jurisdiction. For purposes of this test, activities of the entire expanded affiliated group (generally 50% or greater owned subsidiaries) are taken into account.

Among the concerns cited by the Treasury in the Second Notice is the possibility that a taxpayer might qualify for the "substantial business activities" exception even though that taxpayer is not subject to tax in its jurisdiction of formation. This could occur, for example, because the jurisdiction of organization uses a "management and control" test to determine tax residence, which might allow a foreign acquiring corporation to be tax resident in a jurisdiction with a favorable holding company regime while still being organized in a jurisdiction where the substantial business activities occur.

The rules described in the Second Notice address this perceived concern by requiring the foreign acquiring corporation to be tax resident (and not merely organized) under the laws of the jurisdiction in which the "substantial business activities" are located in order to qualify for the "substantial business activities" exception.

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Under this new rule, certain types of entities will not be able to satisfy the substantial business activities test in any scenario, including:

- A foreign entity that is organized in a third country but nevertheless a tax resident (and therefore subject to tax) in the jurisdiction in which the substantial business activities occur; and
- A foreign entity that is fiscally transparent in its jurisdiction of formation (for example as a partnership) but classified as a corporation or publicly traded partnership for U.S. federal income tax purposes.

The rules are unclear on how the substantial business activities test will apply where the foreign acquiring corporation is tax resident in more than one jurisdiction.

C. New Restrictions on "Out from Under" Planning

The Second Notice describes new regulations that are designed to make post-inversion "out from under" tax planning more difficult to implement. In particular, the Second Notice makes the following two changes:

- Expansion of "Inversion Gain". Under pre-existing law, a U.S. corporation that undergoes an inversion transaction is prohibited from using its tax attributes (such as credits and net operating losses) to offset "inversion gain" directly recognized by the U.S. corporation in the 10-year period following the inversion transaction. Inversion gain includes any income or gain recognized by reason of (i) the transfer of stock or other properties to a foreign related person or (ii) a license of any property to a foreign related person. The Second Notice expands the definition of "inversion gain" to include certain "deemed dividends" realized under the controlled foreign corporation rules when the U.S. corporation indirectly realizes inversion gain through one or more of its foreign subsidiaries.
- Toll-Charge Includes all Built-in Gain for Certain CFC Reorganizations. Under the rules described in the First Notice, a U.S. corporation that undergoes an inversion transaction is often required to recognize income (i.e., a "toll charge") when it exchanges shares in a foreign subsidiary pursuant to a reorganization transaction that would otherwise be tax-free. However, the amount of income recognition is limited to the undistributed earnings and profits of the foreign subsidiary. The Second Notice increases the amount of the "toll charge" for these types of reorganizations to include the entire amount of the built-in gain with respect to the exchanged shares, even if such gain exceeds the undistributed earnings and profits. The purpose of this new rule is to ensure that the "toll charge" includes any unrealized appreciation in the assets of the foreign subsidiary (for example, if the foreign subsidiary has self-created intellectual property).

D. Modifications to the First Notice

1. Relief from "Cash Box" Rule for Active Insurance Companies.

The First Notice described a so-called "cash box" rule whereby stock issued by the foreign acquiring corporation in exchange for "foreign group nonqualified property" (i.e., certain passive assets) would be disregarded for purposes of applying the 60% and 80% ownership tests in certain cases. Several practitioners have pointed out that a literal interpretation of this rule could lead to unintended results with respect to insurance companies, which are generally required to hold passive assets to meet its on-going obligations under its insurance contracts. The Second Notice helpfully provides that final regulations will exclude from the definition of "foreign group nonqualified property" certain passive assets associated with the active conduct of an insurance business.

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2. De Minimis Exception to the "Add Back" Rule

In the First Notice, the Treasury expressed a concern that a U.S. corporation may artificially reduce its size prior to an inversion transaction by making a large dividend distribution to its shareholders. Such down-sizing, if successful, could allow the transaction to fit within the 60% or 80% ownership tests. To address these types of transactions, the First Notice contained a rule that would require the U.S. corporation to "add back" certain non-ordinary course distributions made within the 36 months prior to the inversion transaction, even if such distributions did not have a tax avoidance purpose.

The "add back" rule as described in the First Notice could lead to some unintended results with respect to all-cash (or mostly cash) transactions. In particular, where a purchaser forms a new foreign acquiring corporation with cash and the foreign acquiring corporation uses the cash to purchase the stock of a U.S. corporation, all of the stock issued by the foreign acquiring corporation may be disregarded under the "nonqualified property" rules. If the U.S. corporation is then required to "add back" prior distributions, the foreign acquiring corporation might run afoul of the 80% ownership test.

The Second Notice provides relief for these types of transactions. Specifically, Treasury stated that the final regulations will include a *de minimis* exception such that no "add back" will be required where (i) the ownership percentage, determined without regard to the add-back rules, would be less than five percent (by vote and value) and (ii) after the inversion transaction, former shareholders of the U.S. corporation own in the aggregate less than five percent (by vote and value) of the stock of the foreign acquiring corporation (after applying certain constructive attribution rules). This reasonable *de minimis* limitation is likely to be particularly helpful in the case of leveraged buyouts with little or no management rollover.

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E. Effective Dates

The rules described in the Second Notice will be effective as follows:

- The rules described in Part B (aimed at limiting the ability to engage in inversion transactions) will be effective for transactions closed on or after November 19, 2015, even if the parties had signed binding transaction documents before such date.
- The rules described in Part C (aimed at "out from under" planning) will apply to transactions occurring on or after November 19, 2015, but only for groups that completed an inversion transaction on or after September 22, 2014.
- The rules described in Part D (modifications to the rules described in the First Notice) will apply to groups that completed inversion transactions on or after November 19, 2015 or, if the taxpayer so elects, to groups that completed inversion transactions before November 19, 2015.

F. Future Guidance

The press release accompanying the Second Notice stated that Treasury is actively working on the guidance announced in the First Notice and that it expects to issue such guidance "in the coming months." The Treasury also stated it is still examining additional ways to reduce the benefits of inversion transactions (including guidance on earnings stripping as discussed above) but stressed that Treasury guidance cannot curtail inversion transactions entirely without a legislative change.

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1 For example, the third country may have a more favorable tax treaty with the U.S. than the jurisdiction of the combining foreign corporation so that withholding taxes on interest, dividends, and royalties paid by the acquired U.S. corporation to the foreign acquiring corporation would be reduced.

2 These ownership tests are designed to measure the percentage of the foreign acquiring corporation owned by the former shareholders of the U.S. corporation as a result of the inversion transaction. Where the "ownership percentage" (i.e., the percentage of the foreign acquiring corporation owned by former shareholders of the U.S. corporation) equals 60% or more, a number of adverse tax rules apply to the group, but the foreign acquiring corporation is respected as a foreign corporation for U.S. federal income tax purposes. Where the "ownership percentage" is 80% or more, the foreign acquiring corporation is treated as a U.S. corporation for U.S. federal income tax purposes, thus defeating any tax planning objectives of the transaction.

3 All foreign corporations that are tax resident in the same jurisdiction and acquired in the transaction are aggregated together for this purpose. For example, if the foreign acquiring corporation acquires 3 foreign targets, each with a tax residence in the same foreign country, this requirement would be met, even if no one foreign target meets the 60% test.

4 In fact, none of the rules described in the First Notice or the Second Notice apply to such situations.

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