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The M&A Tax Report

JULY 2016 VOLUME 24, NUMBER 12

The Monthly Review of Taxes, Trends & Techniques

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Cardtronics, Terex, Johnson Controls and Pfizer Face Anti-Inversion Regulations

By Donald P. Board • Wood LLP

It has been several months since the Treasury Department and the IRS launched temporary and proposed regulations on corporate inversions under Code Sec. 7874 (the "new regulations"). The public and political outcry over inversions is rarely very specific, yet these rules are quite nuanced, even arcane. Tax practitioners may have had the time to read the new regulations once or twice.

But reading regulations will take most of us only so far. We need to see the rules in action, in real situations with real taxpayers. So let us take a look at four real-world inversions, and they have fared under the new regime.

Code Sec. 7874 in a Nutshell

Corporate inversion transactions take several forms. But their goal and end-result ought to be the same. They all end with a foreign corporation becoming the new parent of what used to be a U.S. multi-national group.

This change at the top, combined with a bit of post-inversion restructuring, can massively reduce U.S. corporate tax on both the domestic and foreign income earned by the group. Politicians and even the public do not like this.

Code Sec. 7874 tries to distinguish between *bona fide* transactions, which are driven by nontax business considerations, and transactions that are really just about reducing U.S. taxes. The former drain U.S. tax coffers, but Code Sec. 7874 tolerates them. Tax-driven transactions, on the other hand, trigger adverse consequences.

Code Sec. 7874 applies to a corporate inversion if:

- immediately after the transaction, the shareholders of the former domestic parent corporation own at least 60 percent (or, even worse, 80 percent) of the foreign acquiring corporation (the "continuing ownership test"); and

- the expanded affiliated group—*i.e.*, the original U.S. group plus the foreign acquiring corporation and any subsidiaries it has brought with it—does not conduct significant business activities in the country where the foreign acquiring corporation is organized (the "significant business activities test").

If Code Sec. 7874 applies to a transaction and the shareholders of the former domestic parent end up owning at least 60 percent (but less than 80 percent) of the foreign acquiring corporation, the statute limits the inverted group's ability to use its members' losses and other U.S. tax attributes. That is supposed to remove at least *some* of the tax benefits of the inversion.

Hitting 80 percent is more serious. Unless an exception applies, the IRS simply treats the foreign acquiring corporation as a U.S. corporation. That eliminates *all* of the intended tax benefits of installing a foreign parent.

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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.
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Even if shareholders of the U.S. corporation run afoul of the continuing ownership test, the transaction still escapes Code Sec. 7874 if it satisfies the substantial business activities test. "Substantial" means that the expanded affiliated group's operations in the jurisdiction of the foreign acquiring corporation account for at least 25 percent of the inverted group's total employees, payroll, assets and income.

With this framework in mind, let's see how the new regulations have affected four real deals.

Cardtronics: In the Right Place at the Right Time

Convenience-store customers on two continents regularly do business with Cardtronics, the world's largest operator of nonbank ATMs. This multi-national group manages 110,000 "self-service financial kiosks" in the United States, Europe, and Mexico. So group members are generating considerable income, which makes it tempting for a U.S. multi-national to invert.

Cardtronics, Inc. is the group's U.S. parent. But that is going to change. On April 27, three weeks after the release of the new regulations, Cardtronics announced a plan to "redomicile" the group in the United Kingdom. Cardtronics, Inc. will merge into one of its U.K. subsidiaries. Cardtronics PLC, also a U.K. company, will become the new foreign parent of the group.

The United Kingdom is hardly a traditional tax haven—it's too rainy, for one thing. Nevertheless, it has recently emerged as an attractive destination for U.S. corporations eager to invert. Part of its appeal is a low corporate tax rate, currently just 20 percent.

Even more important is the United Kingdom's "territorial" system of taxation. Like its American cousin, the United Kingdom *used* to tax its domestic corporations on their worldwide income, including dividends paid by their foreign subsidiaries. But the United Kingdom faced its own wave of outbound corporate inversions in the 2000s.

Unable to stem the bleeding, Her Majesty's Revenue threw in the towel. The United Kingdom switched to a territorial system in 2009. U.K. corporations no longer have to pay

U.K. tax on profits they or their subsidiaries earn abroad. Many American companies aspire to this goal.

The Cardtronics inversion will give the current shareholders 100 percent of the new foreign parent. If that were the end of the story, the IRS would treat Cardtronics PLC as a U.S. corporation under the 80-percent version of the continuing ownership test.

That is clearly not an acceptable result. But it turns out that Cardtronics already conducts a considerable amount of business in the United Kingdom. Fully 60 percent of its workforce is located there.

The United Kingdom is not Sri Lanka, so it is a safe bet that at least 25 percent of Cardtronics' payroll, assets and income are also attributable to the United Kingdom. Cardtronics does not have to worry about scoring 100 percent on the continuing ownership test. The group's substantial business activities in the United Kingdom will spare it any adverse consequences under Code Sec. 7874.

Terex Tripped up by New Multiple-Step Acquisition Rule

Terex is a U.S. multi-national that manufacturers construction cranes. These are hot commodities in China, which has bought an awful lot of these pricey items over the past decade or two. So the group is presumably swimming in foreign income on which it would prefer not to pay U.S. corporate income tax.

In August 2015, Terex Corporation, the U.S. parent, agreed to merge into a subsidiary of Konecranes Plc, a Finnish corporation that is also in the crane business. The transaction was billed as a merger of equals, but Terex management was going to control a majority of the board of directors. Even more importantly, Terex's shareholders were going to own "approximately 60 percent" of the new foreign parent. Since 60 percent ownership triggers Code Sec. 7874, the parties' vagueness on this point was unusual.

Terex and Konecranes may have been planning to avoid Code Sec. 7874 under the substantial business activities test. Given the 60/40 deal, the expanded affiliated group might well have had 25 percent of its business activities in Finland. If so, the exact ownership percentage would have been irrelevant.

On May 16, however, Terex and Konecranes announced that the deal was off. According to SEC filings, the new tax regulations were to blame. Among other things, the new regulations would "preclude the migration of the combined company to a country other than Finland."

Why would Terex want the newly inverted group to leave Finland? Finland has a 20 percent corporate tax rate, which Terex should have liked. The problem seems to have been the fact that Finland, like the United States, still taxes its domestic corporations on their worldwide income, including dividends from foreign subsidiaries.

Finland will even tax a domestic parent corporation on undistributed income of a foreign subsidiary if the subsidiary's income is taxed at less than 60 percent of the Finnish rate. So it makes sense that multi-national Terex would want to move the post-inversion group out of Finland and into a country with a territorial system. That should completely eliminate host-country taxes on income earned abroad.

But not so fast. New Section 1.7874-2T(c)(4) adopts a special rule dealing with "multi-step acquisitions." Suppose that a U.S. corporation is acquired by a foreign corporation, which is acquired in turn by a *second* foreign corporation. If the two acquisitions are part of a plan, the second-step acquisition will *also* be treated as the acquisition of the U.S. corporation.

In that case, the second-step acquisition will be tested under Code Sec. 7874. It doesn't matter whether the first-step acquisition triggered Code Sec. 7874. The second acquisition stands or falls on its own.

We do not know which country Terex and Konecranes were planning to move to in their second transaction. But with Finland and the United States off the list, there would have been virtually no chance of the second acquisition passing the substantial business activities test.

Everything would have come down to the 60 percent ownership test. Terex might have saved the transaction by agreeing that its shareholders would come away with no more than 59.9 percent of the new foreign parent.

But the parties decided that Terex would sell one of its business units to Konecranes and take a 25 percent equity position in the Finnish company. Taxes appear to have yielded to normal business considerations.

Johnson Controls Does It by the Numbers

Johnson Controls, the auto-parts manufacturer, is one of the 70 largest firms in the United States. In January 2016, it announces a plan to invert with Tyco International plc. (Tyco inverted from the United States to Bermuda in 1997. Then it relocated to Switzerland. Tyco is currently incorporated in Ireland, a country that combines a 12.5 percent corporate tax rate with a territorial system of taxation.)

Johnson Controls is reported to have over $8 billion in overseas profits sitting in its foreign subsidiaries, so the inversion raises significant U.S. tax-policy issues. But the new regulations will not pose a problem. The deal is structured to give the shareholders of Johnson Controls just 56 percent of the foreign acquiring corporation—plus $3.9 billion in cash to even things out.

That keeps the transaction on the right side of the 60 percent trigger, so there should not be any adverse consequences under Code Sec. 7874. The deal may be all about U.S. taxes, but as the CFO told an interviewer, "it's full speed ahead."

Pfizer Fizzles: New "Serial Inversion" Rule

In November 2015, Pfizer, Inc. and Allergan plc announced an inversion that would have been the third largest corporate acquisition in history. Allergan is a tax resident of Ireland. The new Irish corporate parent—to be named "Pfizer plc"—would have headed the world's largest pharmaceutical company.

Pfizer's market capitalization was then about $200 billion. To do an all-stock deal that would not hit the 60-percent trigger, Pfizer needed an inversion partner worth at least $135 billion. Pfizer settled on Allergan plc. Allergan, which sells Botox by the boatload, had a market capitalization of about $120 billion.

After negotiations, Pfizer agreed that Allergan was worth about $160 billion. That meant that Pfizer's stockholders would end up owning just 56 percent of the new Pfizer plc. So far, this sounds a bit like Johnson Controls and Tyco.

But there was a fly in the pharmaceutical ointment. On paper, Allergan was big enough for the inversion to get past Code Sec. 7874. But it had *gotten* big only quite recently. Even worse, it had done so mostly by using its stock to acquire a series of U.S. companies.

That combination is fatal under the new regulations. The percentage ownership of the shareholders of the former U.S. parent is calculated using a fraction whose denominator is the total shares of the post-inversion entity. But new Section 1.7874-8T *excludes* from the denominator any stock of the foreign acquiring corporation that was issued to acquire U.S. companies during the preceding 36 months.

Over half of Allergan's outstanding shares had been issued in recent U.S. acquisitions. Excluding them from the denominator would have left the Pfizer shareholders owning well over 70 percent of the foreign acquiring corporation. Just two days after the new regulations were announced, Pfizer pulled the plug on the deal.

Pfizer has known disappointment before. Its 2014 attempt to force an inversion on the United Kingdom's AstraZeneca ended in failure. Reflecting on the collapse of the Allergan merger, Pfizer's CEO has said that the company has had enough of inversions because the Obama administrations "has made it clear they will do whatever it takes to stop an inversion." The fact that Pfizer is reported to have *$80 billion* in foreign profits parked in its foreign subsidiaries probably has something to do with that.

Conclusion

The new regulations under Code Sec. 7874 sank the Pfizer and Terex inversions. But they do not completely block tax-motivated inversions—Cardtronics and Johnson Control prove that. Recognizing this, the Treasury is now devoting considerable regulatory energy to draining the U.S. tax "juice" out of even successful inversions.

However, capital is mobile, and fewer and fewer countries are even *trying* to tax corporate income earned abroad. The Treasury's campaign against tax-motivated inversions has scored a notable success. But it still looks like an uphill fight.