Inversion Scorecard: President 7, Taxpayers 0

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Inversions are the transaction of the year, month and hour. In the way that much of our tax system seems to react strongly to some perceived abuse, inversions have become a strangely guilty pleasure. They are something U.S. companies have good reason to pursue.

However, there is not even universal agreement about precisely which transactions one should fairly label as an inversion. Then, even if one can agree about the definition of an inversion, how should they be addressed, both prospectively and retroactively? Moreover, is it the inversion itself that is most abhorrent, or is it post-inversion planning that causes more damage to the U.S. tax system?

Regardless of how one answers these questions, it is clear that it is now harder to accomplish an inversion, and more expensive. Inversions are big enough for the President of the United States to be talking about them and naming names. And while some questions remain unanswered, the first wave has arrived.

For a time, there was a debate whether the Treasury Department had the authority and wherewithal to prevent or curtail these transactions. Although there is still some debate, it is now clear that the Treasury did act. It is also clear that it intends its new rules to be followed, and that this is only the first installment.

Take Notice

Notice 2014-52, 12014-42 IRB 1, (the "Notice") adds several rules to make it harder and more expensive to do inversions. One of the primary ways the Notice increases the cost

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of inversions is by limiting access to overseas cash. Yet interestingly, some are noting that the Notice goes beyond inversions.

Intra-group transactions could conceivably be adversely impacted even when entered into in the ordinary course of business or as a necessary part of integrating two formerly separate corporate groups. That is, even if there were no tax motivation for the intra-group transaction in question, there could still be negative repercussions.

The new rules apply to inverted entities that are not treated as domestic corporations under Code Sec. 7874. Generally, this arises in inversions involving a combination of a U.S. and a foreign company in which:

(1) the new multinational entity does not have substantial business activities in the home country of the new foreign parent (usually meaning less than 25 percent of the income, assets and employees in the home country of the new foreign parent); and
(2) the shareholders of the old U.S. parent end up owning at least 60 percent but less than 80 percent of the shares of the new foreign parent.

The rules apply to companies that inverted on or after September 22, 2014. Thus, when these regulations are finalized, which could be a year or more in the future, they will have been in effect for some time. Moreover, most of the rules continue to apply for 10 years *after* the inversion.

The Notice says there will be regulations on the way, addressing inversions by:

(1) minimizing the new foreign parent's ability to access controlled foreign corporation (CFC) cash after an inversion; and
(2) tightening the anti-inversion rules in Code Sec. 7874 to treat more inverted companies as domestic corporations.

New World Order

The Notice attempts to slow down inversions. In a kind of bootstrap, these rules make it more likely that an inversion will be subject to Code Sec. 7874, which dates to 2004. Furthermore, the Notice makes it considerably more difficult to move cash in CFCs owned by the inverted U.S. parent into the new foreign holding company. That cash issue is already having an impact in pending transactions.

Fishing with a Net

The Notice contains several new definitional rules. Not surprisingly, they are intended to snag additional transactions under the 80-percent test of Code Sec. 7874(b). In general, they alter the calculation of the ownership fraction.

Assuming that a threshold test is met, the Notice says we take a portion of the foreign buyer's stock issued to persons other than the U.S. company's shareholders corresponding to the proportion of foreign group assets that are treated as nonqualified property. That amount is excluded from the denominator of the ownership fraction. A higher numerator and smaller denominator makes the deal more likely to be an inversion.

Nonqualified property is everything listed in Reg. §1.7874-4T(i)(7), including cash. There is an exclusion for property used in a banking, financing or insurance business described in Code Secs. 954(h), 954(i) or 1297(b)(2)(A).

What is the threshold for this new regime? The new rule applies only if more than 50 percent of the gross value of the properties of the expanded affiliated group consist of nonqualified property. In making the threshold calculation, the denominator consists of all property of the foreign members of the expanded affiliated group, other than property owned by domestic members or their subsidiaries and other than inter-company obligations and stock.

Who Is Bigger and Why We Care

Is it relevant whether the domestic or foreign company is bigger? Yes. Under Code Sec. 367(a), U.S. shareholders would prefer to have the foreign combining entity be larger than the U.S. company. Because of the obvious incentives this creates, there are rules to prevent stuffing assets into the foreign corporation.

But what about trimming down the domestic one, which could have the same relative impact? Up until now, this was common. But the Notice nixes this, disregarding nonordinary course distributions made during the 36-month period before the inversion.

A nonordinary course distribution is any distribution exceeding 110 percent of the average of distributions made by the U.S. company over the prior 36 months. The rule increases the value of U.S. corporations to the extent they have nonordinary course distributions. Determining what goes into those distributions will really matter.

Finally, note that this distribution rule can obviously increase the value of the U.S. company. However, it can never increase the value of the foreign one. That makes it more likely that Code Sec. 7874 will apply. Even if the foreign company were itself to make extraordinary distributions, that would not count to reduce *its* value.

Stock Attributable to Passive Assets

One must count the relative sizes of the U.S. and foreign companies to determine whether and how the rules of Code Sec. 7874 apply. In that comparison, Code Sec. 7874(c)(2)(B) already disregards certain stock issued in an initial public offering connected with the inversion. The Treasury Department and the IRS have disregarded stock in the foreign merger party that is acquired in a private placement or otherwise for cash and certain other passive assets. The Notice expands on this exclusion for stock attributable to passive assets.

The Notice disregards stock of the foreign parent attributable to passive assets if at least 50 percent of the foreign group's assets are passive. Banks and certain other financial services companies would be exempted.

Subsequent Share Transfers

What happens if the foreign parent in the inversion transfers shares? Code Sec. 7874 already addresses this, but the Notice takes a crack at correcting the statute. First, the Notice says that stock treated as owned by the U.S. company does not lose that taint even if the stock is transferred later.

It does not manner if the subsequent transfer is related to or part of the acquisition. It still does not cleanse the transaction from the applicability of Code Sec. 7874. Second, there are two exceptions from Reg. §1.7874-1(c)(2) and -1(c)(3).

These regulations contain favorable rules designed to loosen Code Sec. 7874's mathematical rules in some cases. The Notice suggests that a U.S. parent might drop stock of a domestic subsidiary into a new foreign subsidiary, and then distribute the stock of the foreign subsidiary to its shareholders. It might even be a tax-free spin-off.

In any case, the Notice says that the exceptions in Reg. §1.7874-1(c)(2) and -1(c)(3) are not going to apply. And that means the transferred shares generally count in both the numerator and the denominator of the ownership fraction, assuming that the subsequent transfer by the corporate shareholder is *related* to the acquisition.

After the Inversion

Inversions do not allow a U.S. company to flee overseas as a way of avoiding paying tax on U.S. based income. Indeed, the income from U.S. operations will still be taxed in the United States after the inversion. Rather, the idea is to allow foreign expansion with the parent company thereafter being foreign so that non-U.S. earnings will not be taxed in the United States.

Given the comparatively high corporate tax rates in the United States, it is not an unreasonable goal. Of course, there are also other aspects that may be less easy to explain, and perhaps less laudable. Some post-inversion planning might consist of attempts to reduce the company's U.S. tax burden with deductible expenses.

Another avenue would be *via* repatriating earnings and profits from CFCs. The Notice takes on this series of issues in several ways: First, there is an anti-hopscotch rule. Second, there is a rule to make de-controlling CFCs less attractive. Finally, there is an application of Code Sec. 304(b)(5)(B).

Hopscotch Is No Game

Up until the Notice, one of the reasons to take advantage of an inversion was to be able to access the untaxed earnings and profits of the CFCs of the U.S. company. But not anymore. The Notice says that inverted companies will not be able to access the untaxed earnings and profits of CFCs. Loans or share purchases are off-limits.

The rule is based on an important principle. U.S. companies that have CFCs usually do not have to pay tax on the profits of their CFCs until they repatriate the profits. That is why so much cash is currently being held offshore. It is also a major bone of tax contention about U.S. tax policy.

To try to access these deferred earnings, many companies have their CFC invest in U.S. property. What about making a loan to, or investing in stock of, its U.S. parent or one of its domestic affiliates? The U.S. parent is treated as if it received a taxable dividend from the CFC.

However, loans from or equity investments by a CFC to a foreign parent, as may arise following an inversion transaction, are not considered U.S. property. Therefore, they do not give rise to a U.S. income inclusion. The Notice says these loans or equity are now "U.S. property." That means the same dividend rules apply as if the CFC made a loan to or invested in the equity of the U.S. parent before the inversion.

And the rules are strict. Whether or not there is a good business reason for the loan, and regardless of whether the loan is repaid, Code Sec. 956 will apply. Even a guarantee of an obligation triggers Code Sec. 956.

In short, all the cash that you *thought* you could access is going to cost you, a lot. The amount of any investment by the U.S. company's CFCs in the stock or debt of a foreign member of the post inversion group is an investment in U.S. property. Code Sec. 956 applies for 10 years after the inversion.

Diluting Ownership of CFCs

Following a combination of U.S. and foreign companies, the new foreign group may want to integrate the foreign operations with the U.S. company's CFCs. This integration can result in diluted U.S. ownership of the CFCs. In fact, it could even lead to loss of CFC status if the foreign parent's ownership exceeds 50 percent.

The government thinks this kind of de-controlling strategy allows the new foreign parent to get the deferred earnings of the CFC without ever paying U.S. tax on them. That, of course, is bad, so the Notice addresses it. In effect, investments by the new foreign parent in a CFC would be treated as if the new foreign parent owned stock in the former U.S. parent.

Therefore, the CFC would remain a CFC, and the U.S. parent would continue to be subject to U.S. tax on repatriation of the CFC's deferred earnings. In addition, the new rules would require a U.S. income inclusion for restructuring transactions that reduce the U.S. group's ownership of a CFC, but that do not eliminate CFC status.

Post-inversion, if a U.S. company were simply to transfer shares of a CFC to the foreign parent (or for that matter, to another foreign member of the post-inversion group), it might be possible to avoid CFC status. That would be slick, but it does not quite work that way. Code Sec. 367(b) would require the U.S. company to pick up the untaxed earnings and profits ("E&P") of the transferred CFC.

But what if the foreign company acting as the buyer in the inversion simply contributes property (which might be stock of the foreign combining party in the inversion) to the CFC for CFC shares? Here, generally neither Code Sec. 1248 nor Code Sec. 367(b) should apply. The U.S. company's ownership of the CFC should be diluted.

That should mean the U.S. company's share of the CFC's untaxed E&P will also be diluted. If the investment is large enough, the CFC may even cease to be a CFC. The notice calls investments that dilute the U.S. company's interest in a CFC "specified transactions." They include any transaction (including sales) in which stock of a U.S. company's CFC is transferred to a newly related foreign affiliate.

And the taint is a long one. If there is a "specified transaction" during the 10-year applicable period, the specified transaction will be recast as a pair of back-to-back transactions. What is the back-to-back recharacterization?

A transfer of property by the foreign company to the domestic company's CFC will be treated as if: First, the foreign company transferred the property to the domestic one. Next, the U.S. company is treated as having transferred the same property to the CFC.

In the first transfer, the U.S. company is considered to have issued instruments identical to those actually issued by the CFC. In that way, when the CFC makes a payment on the actual investment, it will be treated as if the CFC made the payment to the U.S. company, not to the foreign one. Then, it is treated as if the U.S. company made a corresponding payment to the foreign parent.

These are complex provisions, but the result may be a recognition of income by the U.S. company, and even a U.S. withholding tax on the payment to the foreign parent. According to the Notice, the regulations under Code Sec. 367(b) will be amended to require a U.S. shareholder to include the untaxed E&P of a CFC in income on any specified exchange.

In fact, the gain is taxed almost without exception. As a result, the idea of trying to take CFCs of a U.S. company and offload them so they are no longer CFCs without paying tax on the earnings looks impossible. About the only type of transaction that might still be attractive would be where the CFC has somehow paid foreign taxes that generate a foreign tax credit.

Addressing Spin-Offs

The Notice announces rules to amend current regulations that permit, in certain circumstances, a U.S. company to contribute the stock or assets of a U.S. company to a foreign subsidiary and spinning that foreign subsidiary off to its shareholders (sometimes called a "spinversion"). The Notice would apply Code Sec. 7874 to the formation of the foreign subsidiary.

Conclusion

One thing is very clear about Notice 2014-52: it will not be the last piece of guidance from the Treasury Department and the IRS about inversions. If legislation is not forthcoming, as it appears right now not to be, the administrative front will continue to be active. Past and future inverters will be busy, as will their tax advisers. Stay tuned.