Analysis

Inversions of US corporations: the current state of play

Speed read

The US Treasury has recently issued significant federal tax regulations in an attempt to stem the increasing number of tax-motivated corporate 'inversions', whereby a US parented company and a non-US company combine and locate the tax residence of the merged company in a non-US jurisdiction. These regulations not only formally adopted rules from 2014 and 2015 IRS Notices, but also introduced new rules not contained in any prior guidance and made substantive modifications to the rules in the previous notices. Critics would argue that it is the lack of reform to the US corporate tax code which has undoubtedly led and may continue to lead companies to reconsider their US tax residence.

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On 4 April 2016, the US Treasury issued significant federal tax regulations in an effort to deter so-called corporate 'inversions', where a US parented company and a non-US company combine and locate the tax residence of the merged company in a non-US jurisdiction, typically with the US parented company as the larger of the two. The tax regulations adopt and augment administrative guidance issued in September 2014 and November 2015 in the form of IRS notices that had previously sought to deter or prevent such inversions.

The US Treasury has acted because it perceives that: '[T]he primary purpose of an inversion is not to grow the underlying business, maximise synergies, or pursue other commercial benefits. Rather, the primary purpose of the transaction is to reduce taxes, often substantially' (US Department of the Treasury press release, 4 April 2016). This is regardless of the commercial justifications which are often cited by the multinational groups implementing such transactions. Both the number and size of companies seeking to invert out of the US has increased significantly in recent times. Whilst over 50 (formerly) US companies have become 'expatriated entities' since the 1980s, at least 20 of those inversions have occurred since 2012. Furthermore, 2014 saw around 55% of all inversion deals in dollar value since 1996.

Critics of the current US taxation system would argue that the high US corporate tax rate of 35% and the non-territorial basis of taxation are the principal reasons why some US companies have sought to relocate to lower tax jurisdictions. The growth in number and significance of such inversions must also be seen in the context of wider international tax competition, which has forged ahead alongside greater political and social pressure on multinational companies to pay their 'fair share', as it has become known. The UK is probably the best example of a jurisdiction using tax policy to increase corporate investment, whilst being at the forefront of international tax reform.

The lack of reform to the US corporate tax code has undoubtedly led, and may continue to lead, companies to reconsider their US tax residence. This issue was specifically considered by the Ways and Means Committee of the US House of Representatives on 24 February, amid concerns over inversions and longer term erosion of the US tax base. However, to date, the US Treasury has been forced to work within the existing legislative framework to counter existing and prospective inversion transactions.

The anti-inversion rules prior to 4 April 2016

Although inversions have courted significant recent attention, the US Internal Revenue Code has since 2004 contained an anti-inversion rule under section 7874. Under section 7874 generally, a non-US acquiring corporation is treated as a US corporation for all US tax purposes if it acquires substantially all of the stock (or property) of a US target corporation; and if the shareholders of the US target corporation receive *at least 80%* of the non-US acquirer stock in the exchange. The statutory rule was originally introduced to counter the most basic of inversions, such as where a US corporation's shareholder would form a new shell holding company in a tax-favourable jurisdiction and transfer all of the US corporation's stock to the non-US holding company in exchange for all of the non-US holding company stock.

In recent years predating the 2014 Notice, US corporations were inverting by combining with a smaller non-US corporation that was just large enough to ensure that the shareholders of the US corporation received less than 80% of the non-US acquiring corporation stock, thereby avoiding the most drastic consequences under section 7874. A non-US acquiring corporation remains a non-US corporation for US tax purposes under section 7874 when the US target corporation's shareholders receive less than 80% of the non-US acquiring corporation stock in the exchange. However, section 7874 denies the US corporation the use of certain US tax attributes, such as net operating losses and foreign tax credits to offset gain or income resulting from certain post-inversion restructuring transactions, when the shareholders of the US target corporation receive *at least 60%, but less than 80%*, of the non-US acquirer stock in the exchange. Prior to the 2014 Notice, many companies were willing to live with this cost, as long as they did not run afoul of the 80% inversion threshold.

In response to the rise of inversions falling within the 60 to 80% range, the IRS and US Treasury issued a notice in September 2014 specifically seeking to counter transactions which it perceived as seeking to manipulate the percentage tests. In particular, for the purposes of determining whether the 60% and 80% tests are satisfied,

the September 2014 Notice makes the following changes:

- The relative size of a non-US acquiring corporation is decreased for the purposes of calculating the ownership fraction, if more than 50% of the value of the assets held by such a non-US acquiring corporation and its affiliates consist of passive assets. For example, if a non-US corporation that owns only cash and has 100 shares outstanding acquires a US corporation for 150 additional shares, what would have been a 60% inversion (150/250) becomes a 100% inversion because the stock of the non-US corporation attributable to passive assets is disregarded.
- Certain distributions made by the US corporation during the 36 months preceding an inversion are ignored. This means that if a US corporation 'slims' itself down by making a non-ordinary course distribution prior to an inversion, so that its shareholders will receive less stock of the non-US acquiring corporation, the distribution will be treated as if it had never occurred. The US corporation shareholders will be deemed to receive additional non-US acquiring corporation stock with fair market value equal to the amount of the distribution.
- It subjects certain types of complex spin-offs (so-called 'spinversions') to section 7874.

These aspects of the 2014 Notice sought to prevent taxpayers from using self-help transactions to avoid running afoul of the 80% inversion threshold. For example, they prevented a non-US acquirer from creating a cash-box non-US corporation solely to acquire a US target in an inversion that avoided section 7874 solely because of the cash owned by the non-US company. At the same time, these rules prevented US corporations from reducing their value by distributing cash and other assets to their shareholders before an inversion.

Further, the September 2014 Notice sought to make inversions less attractive economically by preventing US corporations from benefiting from the longer-term tax consequences resulting from an inversion that falls within the 60% to 80% range, by introducing rules as follows:

- Under US law, if a non-US subsidiary controlled by a US corporation makes a loan to that corporation, the amount of the loan is treated as a dividend paid by the non-US lender to the related US borrower. To circumvent such a deemed dividend following a 60% inversion, non-US subsidiaries of an inverted US corporation would make loans directly to the new non-US ultimate parent, thereby 'hopscotching' the US corporation while still moving untaxed cash up the chain of ownership. The 2014 Notice treats such a loan as the equivalent of a loan to the inverted US corporation that remains subject to deemed dividend treatment.
- It prevents the tax-free decontrolling of a non-US corporation controlled by a US corporation following an inversion.
- It prohibits certain related-party stock sales from being used to strip the earnings of a non-US subsidiary controlled by a US corporation following an inversion.

However, the IRS and US Treasury believed that the 2014 Notice did not sufficiently deter companies from pursuing inversions, as transactions could still be structured in a way that ensured the inversion could be implemented without being subject to section 7874. For example, even taking into account the rules above, non-US acquiring corporations could still acquire a US corporation in an inversion using a carefully calculated ratio of cash and stock consideration, sourced by the non-US acquiring corporation in a manner that ensured the US corporation's shareholders did not run afoul of the inversion thresholds.

Moreover, the rules in the 2014 Notice limiting certain post-inversion tax planning had targeted inversions where the US corporation's shareholders received 60% or more of the non-US acquiring corporation stock in the exchange. To circumvent the restrictions in the Notice, more deals began targeting inversion percentages under 60%.

The IRS and US Treasury therefore issued a further Notice in November 2015 to counter other issues they saw in inversion transactions:

- Under the statute, section 7874 does not apply if the non-US acquiring corporation's group has 25% of its worldwide assets, income and employee base in the country where it is organised. The Notice denies this exception to section 7874 for 'substantial business activities', unless the non-US acquiring corporation's group (determined after the inversion transaction) has substantial business activities in the country where its parent is *tax resident*, rather than just the country where the parent is organised.
- It treats what would otherwise be a 60% inversion as a *per se* 80% inversion, if a non-US corporation and US corporation are each acquired by a new non-US acquiring corporation organised in a third country. (This was introduced in part to stop tax-motivated inversions to, say, Ireland, where the non-US acquiring corporation was not already an Irish company.)
- It treats 'indirect' transfers of property by a US corporation after a 60% inversion as if directly made by the US corporation for US tax purposes, thereby triggering the limitations on use of tax attributes described above.

Nevertheless, high profile inversions remained active when the US Treasury introduced its most recent measure on 4 April 2016.

The anti-inversion regulations issued on 4 April

The anti-inversion regulations issued on 4 April 2016 formally adopted the rules from the 2014 and 2015 Notices as regulations with the force of law. However, the regulations did not stop there, and also introduced new rules not contained in any prior guidance, as well as substantive modifications to the rules in the previous notices. These new rules and modifications to the notices are effective for transactions completed on or after 4 April 2016.

> Businesses should expect further strengthening of the anti-inversion rules and potentially tax disincentives, restricting but not eliminating the feasibility of inversions in the short and medium term

Chief among the new rules is the so-called 'serial inverter' rule. For the purposes of calculating the inversion ownership fraction with respect to a new acquisition, this rule generally disregards all non-US acquiring corporation stock issued (or deemed to be issued) in acquisitions of US corporations occurring within the 36-month period ending on the date a new acquisition becomes subject to a binding contract. These regulations contain an anti-avoidance rule

that disregards the termination of an existing contract signed within this 36-month period when the parties to that terminated contract enter into the same or a substantially similar contract outside the 36-month period.

This serial inverter rule has the effect of increasing the likelihood that the non-US acquiring corporation shares issued in the new acquisition to the US corporation shareholders will represent 60% (and maybe 80%) of the adjusted number of outstanding shares of non-US acquiring corporation stock, thus increasing the likelihood that the new acquisition will be subject to the consequences of section 7874.

The proposed earnings stripping regulations issued on 4 April

Inversion transactions have historically been structured in a way which maximises debt in the remaining US group, thereby providing longer term tax benefits. The effect of the related party debt is to shift income from the high-tax jurisdiction (US) to the new lower tax jurisdiction. Consequently, in the Notices, the US Treasury notified taxpayers that it was considering the issuance of anti-earnings stripping regulations to deter the perceived unwarranted erosion of the US tax base using related party debt.

The proposed earnings stripping regulations are actually much, much broader than anticipated and would apply, as drafted, to the treatment of *any* debt between US related parties (other than those in a US consolidated group), as well as US to non-US related parties and even non-US to non-US related parties, to the extent that the US federal tax treatment of their related-party debt is relevant. Consequently, the proposed regulations apply not only to debt issued by inverted companies but, generally, to all debt between corporations (non-US and US) related through direct, or indirect, stock ownership of 80% of the voting power or value. If finalised in their current form, certain of these regulations will apply to debt issued on or after 4 April 2016.

Specifically, the proposed regulations:

- specify due diligence and documentation that must be undertaken and maintained in order for certain related-party debt to have the possibility of being respected as debt for US federal tax purposes;
- enable the IRS to treat certain related-party debt as partially debt and partially equity; and
- require certain related-party debt to be *per se* treated as stock of the issuer.

The effect of an application of these rules would be to deny any interest deduction taken with respect to recharacterised debt; and to recharacterise any payments made on the debt as distributions on stock (potentially treated as dividends for US tax purposes).

If implemented, these rules will significantly affect an inverted US corporation's ability to reduce its taxable income by way of making related-party interest payments. For example, following an inversion to Ireland, a US corporation could traditionally distribute a debt instrument to its new Irish parent. Interest on the debt instrument would be deductible at the US corporate rate of 35%, but only taxable in Ireland at a rate as low as 12.5%. Under the proposed anti-earnings stripping regulations, the debt instrument issued by the US corporation would be treated as *per se* equity, meaning that interest payments would instead be treated as non-deductible distributions potentially taxable as dividends, and repayments of principal would be treated as taxable stock redemptions (i.e. likely as additional dividends). In short, the proposed regulations would make it extremely difficult to utilise cross-border intercompany debt to lower a multinational's effective tax rate after an inversion.

Example: Operation of serial inverter rule

Assume that non-US Company A is worth $100 in year 0.

- In year 1, Company A acquires US Company B in exchange for $50 of Company A stock.
- In year 2, in a transaction unrelated to the year 1 acquisition, Company A acquires US Company C in exchange for another $50 of Company A stock.
- Finally, in year 3, in a transaction unrelated to the acquisitions in years 1 and 2, Company A acquires US Company D in exchange for $150 of Company A stock.

Absent the serial inverter rule, the Company D shareholders would own $150/$350 or 43% of the Company A stock post-inversion.

Under the serial inverter rule, Company A's acquisitions of Company B and Company C stock are disregarded when determining whether the Company D acquisition is a 60% or 80% inversion. As a result, Company A is treated as if it were worth $100 before the acquisition of Company D, and Company D's shareholders are deemed to own $150/$250 or 60% of Company A after the transaction, resulting in a 60% inversion.

The future of inversions?

There is no doubt that the combination of the anti-inversion regulations and proposed earnings stripping regulations issued on 4 April 2016 now pose a significant deterrent to inversion transactions. This is combined with the wider political and social disapproval of such transactions, which are seen domestically in the US by some as unpatriotic. Indeed, both leading US presidential candidates have expressed negative views on inversions and an intention to clamp down further on (and even punish) corporations that have sought or are seeking to relocate outside the US.

In spite of this, it is unlikely that the measures will completely deter US based groups from seeking to relocate overseas, especially given the significant sums that can be saved. In order to do so, the US may need to undertake substantial tax reform that eliminates the motivation behind the companies seeking to relocate.

Wider tax reform is on the agenda in the US, and there is to some extent bipartisan agreement on the need to reform the US corporate income tax rules, including introducing a lower rate. The difficulty is that in many respects there is no clean dichotomy between the corporate and individual tax rules and rates in the US. Many businesses (excluding the largest corporations) operate using pass-through entities, which pass income through to individuals and generally enjoy a single level of taxation and thus lower effective rates. The corporate and individual tax rules are therefore inextricably linked, and opinions differ significantly – on all sides of the political spectrum – with respect to individual tax rate cuts. In the meantime, businesses should expect further strengthening of the anti-inversion rules and potentially tax disincentives, restricting but not eliminating the feasibility of inversions in the short and medium term. ■

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