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Treasury Department Issues New Regulations to Further Limit Corporate Inversions and New Debt/Equity Regulations to Limit Earnings Stripping

On April 4, 2016, the Treasury Department issued a broad package of temporary and proposed regulations (the "Regulations") intended to reduce the benefits—and limit the number—of corporate inversions, including via the introduction of proposed earnings stripping rules. The principal rules announced in prior anti-inversion Notices, as modified in certain cases by the Regulations, as well as the principal new anti-inversion and earnings stripping rules, are summarized below.

I. Corporate Inversions Generally

A corporate inversion generally is a transaction that results in a U.S. corporation or partnership (a "U.S. target") adopting a foreign domicile or becoming a subsidiary of a foreign parent corporation. After an inversion, the U.S. target may be able to use its (or its foreign parent's) tax residence abroad to reduce U.S. taxes. An inversion is frequently accompanied or followed by transactions intended to remove the U.S. target group's foreign income from the U.S. tax net. The U.S. target group may direct subsequent expansion of its business offshore, and portions of its existing business may also tend to migrate offshore. The U.S. target group also may reap additional benefits by reducing U.S. tax on its domestic income by means of earnings stripping (e.g., making deductible interest payments to non-U.S. affiliates to reduce the U.S. target group's taxable income).

II. Statutory Background

Section 7874 of the Internal Revenue Code is intended to forestall the erosion of the U.S. tax base resulting from corporate inversions. In general:

- *80% Rule.* If the former shareholders of a U.S. target are deemed to own at least 80% (by vote or value) of the stock of the redomiciled U.S. target or its new foreign parent (each, a "foreign acquiror") by reason of holding stock in the U.S. target, the foreign acquiror will be recharacterized as a U.S. corporation for all U.S. tax purposes. (There is an exception if the foreign acquiror group has substantial business activities in the country where it is organized.)

- *60% Rule.* Less draconian rules apply if the former shareholders of a U.S. target are deemed to own at least 60% (but less than 80%) of the stock of the foreign acquiror by reason of holding stock in the U.S. target. In that case, the acquiror will be respected as foreign, but (assuming the substantial business activities test is not met) certain income or gain ("inversion gain") recognized by the U.S. target and certain related U.S. persons will be subject to U.S. tax. Inversion gain includes any income or gain recognized during the 10-year period beginning with the inversion by reason of the transfer or license of assets in the inversion or to a foreign related person after the inversion. Importantly, the tax on inversion gain cannot be offset by credits, net operating losses, or other tax attributes.

III. Prior Administrative Guidance

Prior to the issuance of the Regulations, in response to concerns that Section 7874 had proven ineffective, the IRS issued extensive anti-inversion guidance in the form of two Notices. That guidance has now been adopted, with certain modifications, by the Regulations as summarized below.

A. Notice 2014-52.

The Regulations adopt the following anti-inversion rules previously announced in Notice 2014-52, issued on September 22, 2014, which generally apply retroactively to transactions occurring on or after that date:

- *Cashbox Rule*. If more than 50% (by gross value) of a foreign acquiror group's assets consist of cash, marketable securities, obligations of certain affiliates, or certain other property intended to circumvent Section 7874, a corresponding portion of the foreign acquiror's outstanding stock will be disregarded in applying the 80% and 60% ownership percentage tests described above (the "shareholder continuity test").
    - *Exception.* This rule generally does not apply to certain financial institutions, including foreign insurance companies conducting an active insurance business.
- *Non-Ordinary Course Distributions by a U.S. Target*. Certain extraordinary distributions made by a U.S. target to its shareholders during the 36-month period before an inversion will be disregarded in applying the shareholder continuity test, with the result that U.S. target shareholders will be deemed to receive additional stock of the foreign acquiror in the inversion transaction. The additional stock will be deemed to be equal in value to the disregarded distributions.
    - *110% Rule*. Distributions (which include stock buybacks) during a taxable year generally will be treated as extraordinary to the extent they exceed 110% of the average annual distributions made during the preceding 36 months.
    - *Reverse Spin-Offs*. A special rule applies where a U.S. parent has distributed the stock of the U.S. target in a reverse tax-free spin-off (<u>i.e.</u>, the U.S. target was larger than the remainder of the U.S. parent). In that case, the U.S. target is deemed to have distributed the remainder of the U.S. parent.
- *Spinversions*. A favorable rule that generally applies to the calculation of the shareholder continuity percentage in the case of internal group restructurings will not apply where a U.S. parent contributes the U.S. target to a foreign subsidiary and then spins off the foreign subsidiary to the U.S. parent's shareholders (a "spinversion").
- *Anti-Hopscotch Rule*. If the U.S. target or a related U.S. person owns (or is deemed to own) 10% or more (by vote) of a controlled foreign corporation ("CFC"), certain loans by the CFC to the foreign acquiror (or certain foreign related persons), or similar equity investments by the CFC, made during the 10-year post-inversion period (or prior to the inversion in a related transaction) will result in deemed dividends. Deemed dividends will also result from certain pledges or guarantees made or treated as made by the CFC in respect of obligations of the foreign acquiror (or certain foreign related persons).
- *Decontrol or Significant Dilution of CFC Ownership*. Certain transactions involving the issuance or transfer of stock of a CFC to the foreign acquiror and other non-CFC foreign related persons during

the 10-year post-inversion period are recharacterized to prevent termination of CFC status or dilution of the U.S. target's interest in the earnings of the CFC.

- *Exception.* There is a de minimis exception if the aggregate post-transaction ownership percentage (by value) of the CFC held by persons other than non-CFC foreign related persons is at least 90% of the pre-transaction ownership percentage, and the CFC remains a CFC.

- *Related-Party Stock Sales.* Rules governing the treatment of certain related-party stock sales are modified to prevent a CFC's deferred earnings from being effectively repatriated without the imposition of U.S. tax. This rule applies, for example, to a sale by a foreign acquiror of a portion of U.S. target stock to a related CFC.

B. Notice 2015-79.

The Regulations adopt, with certain modifications, the following anti-inversion rules previously announced in Notice 2015-79, issued on November 19, 2015, which are generally retroactive to transactions completed on or after that date:

- *Subject-to-Tax Rule.* The substantial business activities exception to Section 7874 is further tightened so that it will be satisfied only if the foreign acquiror is also subject to tax as a resident in the foreign country in which it is organized.

- *Third-Country Transactions.* In certain circumstances, stock issued by a foreign corporation that is tax resident in one country to the shareholders of a foreign target corporation that is tax resident in another country in a transaction related to a U.S. inversion will be disregarded in applying the 80% shareholder continuity test.

  - *60% Minimum.* This rule applies where the shareholder continuity percentage would otherwise be at least 60% but less than 80%.

  - *Example.* Assume Irish Acquiror first acquires UK Target in a stock-for-stock exchange and then acquires U.S. Target in a second stock-for-stock exchange. Irish Acquiror is newly formed and has no other assets. U.S. Target is approximately twice as large as UK Target. The acquisition of U.S. Target by Irish Acquiror would have resulted in a shareholder continuity percentage of approximately 67% (i.e., at least 60% but less than 80%). Therefore, the stock issued by Irish Acquiror to the former shareholders of UK Target will be disregarded, the acquisition of U.S. Target by Irish Acquiror will result in a shareholder continuity percentage of 100%, and Irish Acquiror will be treated as a U.S. corporation subject to U.S. tax.

- *Anti-Stuffing Rule.* Certain rules preventing taxpayers from increasing the size of the foreign acquiror will apply to any assets (not only passive assets) acquired by the foreign acquiror in exchange for its stock in a transaction (or series of related transactions) related to the acquisition of a U.S. target with a principal purpose of avoiding Section 7874.

- *Additional Rules.* The Regulations also adopt the following rules previously announced in Notice 2015-79 that target certain post-inversion transactions (which generally apply retroactively to post-inversion transfers completed on or after November 19, 2015, where the inversion transaction was completed on or after September 22, 2014):

a) The definition of inversion gain is expanded to include income or gain recognized by a U.S. target or certain related U.S. persons arising indirectly as a result of certain transfers or licenses of property by a CFC to related persons.

b) A U.S. target or any related U.S. person generally must recognize the full amount of gain (not limited to the CFC's deferred earnings) in the stock of a CFC in certain restructuring transactions; however, there is a de minimis exception if the aggregate post-transaction ownership percentage (by value) of the CFC held by persons other than non-CFC foreign related persons is at least 90% of the pre-transaction ownership percentage.

IV. New Rules in the Regulations

A. New Anti-Inversion Rules.

The Regulations provide additional rules that further limit corporate inversions, including the following:

- *Multi-Step Acquisitions*. The acquisition by a foreign corporation of a foreign acquiror following an inversion pursuant to a plan (or a series of related transactions) is treated as an acquisition of the U.S. target. Stock of the subsequent foreign acquiror received in exchange for stock of the initial foreign acquiror is treated as received by the former owners of the U.S. target by reason of their ownership of U.S. target stock. Thus, Section 7874 may apply to both the initial acquisition of the U.S. target and the subsequent acquisition.

- *Serial Acquisitions of U.S. Targets*. For purposes of calculating the shareholder continuity percentage (by value), stock issued by the foreign acquiror in the prior acquisition of another U.S. target within a 36-month period generally is disregarded, with adjustments for redemptions by, and other capital structure changes to, the foreign acquiror. This rule applies whether or not the previous U.S. target was acquired pursuant to an overall plan.

  - *Pfizer/Allergan*. The CEO of Allergan has blamed this new rule for the termination of Allergan's previously-announced merger with Pfizer.

  - *Example.* Assume Foreign Acquiror acquires U.S. Target A on June 30, 2016 in a stock-for-stock transaction. The shareholders of U.S. Target A receive Foreign Acquiror stock with a value of $2 billion. Foreign Acquiror then acquires U.S. Target B on June 30, 2018 in a second stock-for-stock transaction (whether or not as part of an overall plan). There are no redemptions by or other capital structure changes to Foreign Acquiror during the two-year period between acquisitions. On June 30, 2018, the stock previously issued by Foreign Acquiror to shareholders of U.S. Target A is valued at $2.5 billion. In determining the shareholder continuity percentage for the acquisition of U.S. Target B, the value of the Foreign Acquiror stock outstanding on June 30, 2018 is reduced by $2.5 billion.

- *CFC Asset Dilution*. A CFC will be required to recognize all gain (but not loss) on certain asset transfers to another foreign corporation within the 10-year post-inversion period.

- *Effective Dates*. The new anti-inversion rules, including any modifications to the rules in the two prior Notices, generally apply to acquisitions or post-inversion transactions completed on or after April 4, 2016. The new CFC asset dilution rule applies only if the inversion was completed on or after September 22, 2014.

B. New Earnings Stripping Rules

New earnings stripping rules are proposed to apply to debt instruments issued to certain related corporations and partnerships. While primarily directed at debt instruments issued in the cross-border context, the new rules will also apply in other circumstances.

- *Scope*. The new earnings stripping rules will generally apply to debt instruments issued to certain domestic or foreign related parties, but not to another member of a consolidated group of domestic corporations.

    - *Debt Instrument.* The term "debt instrument" is defined broadly to include any obligation otherwise treated as indebtedness under general tax principles.

- *Documentation Rule*. The new earnings stripping rules generally will require the issuer to prepare documentation for each related-party debt instrument issued on or after the date the proposed regulations are adopted in final form showing (i) the existence of a binding obligation to repay a sum certain, (ii) the holder's creditor rights, including a right superior to stockholders to share in the issuer's assets in liquidation, (iii) a reasonable expectation of repayment, and (iv) a genuine ongoing creditor/debtor relationship. The required documentation:

    a) may include cash flow projections, financial statements, business forecasts, asset appraisals, and determinations of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages);

    b) will be required to include evidence that principal and interest are timely paid, or, in the event of nonpayment, reasonable exercise of the diligence and judgment of a creditor; and

    c) will be necessary whether or not a related-party debt instrument is issued in connection with a corporate inversion.

- *Timely Preparation*. Documentation showing the unconditional obligation, creditor's rights, and reasonable expectation of repayment will be required no later than 30 days after the date of issuance, and documentation evidencing payments of principal and interest and, in the event of default or similar event, the exercise by a holder of the reasonable diligence and judgment of a creditor, will be required no later than 120 days after each payment of principal or interest is due, or an event of default or similar event has occurred.

- *Maintenance*. The taxpayer will be obligated to maintain the required documentation until the relevant period of limitations expires.

- *Exception.* The documentation rule will not apply if (i) no stock of the issuer or any member of the issuer's group is publicly traded, and (ii) no relevant financial statement shows total assets exceeding $100 million or annual total revenue exceeding $50 million.

  - *Relevant Financial Statement.* A relevant financial statement generally is one that (i) is certified and audited or filed with a government or agency, and (ii) includes the total annual revenue or any portion of the assets of the issuer or certain related parties.

- *Failure to Comply.* Failure to comply with the documentation rules will, subject to a reasonable cause exception, result in the related-party debt instrument being treated as equity (unless the taxpayer affirmatively seeks to treat the related-party debt instrument as equity).

- *Bifurcation*. In the case of a related-party debt instrument issued on or after the date the proposed regulations are adopted in final form, the IRS (but not a taxpayer) will be able to treat part of the instrument as equity and part as indebtedness.

- *Rules for Distributions, etc*. In the case of a related-party debt instrument issued on or after April 8, 2016, subject to certain transition rules, the instrument will generally be treated as equity if issued:

  a) as a distribution or in certain other transfers to a related corporation;

  b) to a related corporation in a transaction with a principal purpose to fund a transaction described in (a) above;

  c) with a principal purpose of avoiding (a) or (b) above (e.g., where a debt instrument is issued to an unrelated person but is then acquired by a related corporation as part of a plan).

  - *Conclusive Presumption.* The existence of a principal purpose to fund a transaction described in (a) will generally be determined based on all relevant facts and circumstances, but it will be conclusively presumed for non-ordinary course debt instruments issued to a related corporation during the 72-month period beginning 36 months prior to, and ending 36 months after, the issuer makes the relevant distribution or other transfer.

- *Exceptions.* The rules for distributions, etc., of related-party debt instruments will not apply if (i) the issuer has sufficient current earnings and profits to cover the relevant distributions or acquisitions, or (ii) the adjusted issue price of the debt instrument (and other outstanding related-party debt instruments of the issuer and related persons) is no more than $50 million.

- *No Affirmative Use*. The new earnings stripping rules will not apply to a debt instrument issued in a transaction with a principal purpose of avoiding taxes by benefiting from those rules.

- *Rules are Additive*. The earnings stripping rules will generally apply in addition to, and not in lieu of, existing common law debt/equity and other principles (e.g., the economic substance doctrine and the existing earnings stripping rules of Section 163(j) of the Code).

- *Blocker Companies*. The IRS has requested comments on whether similar earnings stripping principles should be applied to debt instruments issued by a blocker company.

V. Impact of Regulations

While many of the rules in the Regulations are not unexpected due to the two prior Notices, the impact of the Regulations is likely to be significant and should be carefully considered in assessing the merits of any potential inversion or related-party debt issuance.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please call or email Benjamin J. Cohen at 212.701.3853 or bcohen@cahill.com, Craig Horowitz at 212.701.3856 or chorowitz@cahill.com, or Jay Geiger at 212.701.3195 or jgeiger@cahill.com.