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International Tax

United States Tax Alert

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Treasury Anti-Inversion Notice

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On September 22, 2014, the United States Treasury issued Notice 2014-52 (the Notice), which announces its intent to issue regulations that would (i) increase the effective tax rate to foreign acquirers of US targets by limiting the opportunities to achieve tax efficiencies in the course of integrating the operations, management, and financing of the businesses, and (ii) tighten the anti-inversion rules of section 7874. This generally would directly increase US targets' tax costs and thereby reduce the after-tax returns for their foreign acquirers. The Notice announced the intent that future regulations issued thereunder apply to inversion transactions completed on or after September 22, 2014. However, the regulations under section 956 and 7701(l) only apply if the inversion transaction occurs on or after September 22, 2014, and the positions subject to those rules are also entered into or completed after that date.

The Notice follows various legislative proposals with similar objectives. (For coverage of these proposals, see U.S. International Tax alerts dated May 21, 2014 and September 11, 2014.)

Background

Generally, for section 7874 to apply to an foreign acquisition of a US target, there must be a direct or indirect acquisition of substantially all the target's assets, ownership continuity of at least 60% of the acquirer's stock by reason of equity in the target (the ownership continuity test), and lack of substantial business activities by the foreign acquirer's worldwide group in the country where the acquirer is organized (more specifically, the expanded affiliated group, or EAG, which generally refers to the foreign acquirer and its direct and indirect greater-than-50% subsidiaries). If the ownership continuity test is satisfied at the 60% level, generally section 7874 denies the use of tax attributes to reduce tax attributable to transfers of assets by the target to related foreign persons. If the ownership continuity test is satisfied at the 80% level, generally section 7874 instead treats the foreign acquirer as a US corporation for US tax purposes.

Overview of Notice

A focus of the announced regulations is addressing acquisitions that would otherwise run afoul of section 7874 (i.e., meeting the three requirements discussed below, which are generally an acquisition of a US target, ownership in the foreign acquirer by reason of equity in the US target at the 60% level, and lack of substantial business activities in the foreign acquirer's country). Thus, an impact of the regulations would be to generally limit the tax efficiencies that can be achieved in business-driven M&A transactions where owners of the US target acquire at least 60% of the equity in the foreign acquirer by reason of their equity in the US target. The Notice also alerts taxpayers that Treasury is considering tightening rules on otherwise-permissible leveraging of US subsidiaries of a foreign parent.

Analysis of Notice

Anti-Inversion Standard and Passive Assets of Foreign Acquirer

In applying the ownership continuity test, Treas. Reg. §1.7874-4T generally disregards (in both the numerator and denominator) shares of the foreign acquirer issued for cash, cash equivalents, obligations of related persons, and property acquired with a principal purpose of avoidance (defined as nonqualified property). Using the broad authority to modify the anti-inversion rules under section 7874(c)(6), the Notice announced that Treasury and the IRS intend to issue regulations expanding the reach of Treas. Reg. §1.7874-4T in the case of acquisitions where over 50% of the foreign acquirer's EAG constitutes nonqualified property (i.e., so-called cash boxes) by reducing the denominator of the ownership continuity percentage's testing fraction; generally, the reduction is akin to reducing the denominator (equity in the foreign acquirer) by the fraction equal to the ratio of the group's nonqualified property to its total property.

Anti-Inversion Standard and Distributions by US Target

Pursuant to the broad anti-avoidance rule of section 7874(c)(4), the Notice announced that Treasury and the IRS intend to issue regulations expanding the reach of section 7874 by disregarding non-ordinary course distributions by the US target during the 36-month period ending on the acquisition date as well as cash or other property received by shareholders of the US target in connection with the acquisition. In other words, the regulations generally would change the application of the ownership continuity test by increasing the numerator and denominator of the ownership continuity's testing fraction. Non-ordinary course distributions generally are those in excess of 110% of the average during the 36-month period preceding the year of the acquisition. (The Notice also announced that a comparable look-back rule will be added to tighten the testing for substantiality for purposes of the limited exception to gain recognition under Treas. Reg. §1.367(a)-3(c).)

Anti-Inversion Standard and Spin-Offs

Generally, Treas. Reg. §1.7874-1 applies the ownership continuity test by disregarding shares of the foreign acquirer held by members of the EAG (the EAG rule), subject to two exceptions created by Treasury and the IRS. Generally, shares of the foreign acquirer held by an EAG member are included in the denominator but not the numerator (i.e., diluting the testing fraction to facilitate business combinations without application of section 7874) in (i) internal group restructurings where the common parent of the EAG owns at least 80% of the US target before the acquisition and at least 80% of the foreign acquirer afterward (the internal restructuring exception) and (ii) transactions where there is a loss of control (i.e., where the former owners of the US target do not hold in the aggregate directly or indirectly more than 50% of any member of the foreign acquirer's EAG).

The Notice announced that Treasury and the IRS intend to carve back the EAG rule and its internal group restructuring exception; generally, if stock of the foreign acquirer is re-transferred in a transaction related to the acquisition, the stock is not treated as held by a member of the EAG (i.e., the transferred stock is included in the numerator and denominator of the ownership continuity testing fraction). The carve back does not apply in the case of a US parented group if (i) before and after the acquisition the target shareholder is a member of the EAG and (ii) after the acquisition and all related transfers of the foreign acquirer stock the foreign acquirer and holder of the re-transferred stock are members of the EAG. The carve back does not apply in the case of a foreign parented group if (i) before the acquisition the target and transferor of the re-transferred stock are members of the same EAG and (ii) after the acquisition the re-transferor is a member of the EAG or would be absent the transfer of stock in the foreign acquirer by a member of the EAG in a transaction related to the acquisition.

The carve back would have the effect of denying use of the EAG rule and internal group restructuring exception in situations where a US subsidiary of a US multinational transfers substantially all its assets to a new foreign subsidiary and the shares of the new foreign subsidiary are distributed to the public in a section 368(a)(1)(D) reorganization and section 355 spin-off. As a result, the new foreign acquirer would be treated as a US corporation by application of the general rules of section 7874. Treasury alerted taxpayers that it was considering this treatment of divisive transactions in the preamble that accompanied Treas. Reg. §1.7874-4T and -5T in January 2014, as well as in the preamble to final regulations issued under section 7874 in June 2012.

Inversions and Use of Offshore Cash

Generally, section 951(a)(1)(B) together with section 956 cause a U.S. shareholder of a controlled foreign corporation (CFC) to have taxable income akin to a deemed dividend in respect of the US shareholder's pro rata share of the CFC's investment in US property. (Generally, a US shareholder is a US person holding shares with at least 10% voting power in respect of a relevant foreign corporation; generally, a CFC is a foreign corporation whose stock is over 50% [by vote or value] held in the aggregate by US shareholders.) Over time, Congress has passed various rules to define what constitutes US property in order to prevent repatriation of US earnings without US tax.

Using the authority under section 956(e), the Notice announced that Treasury and the IRS intend to issue regulations to change the statutory definition of "US property" to include investments in stock or obligations of related foreign persons within the meaning of section 7874(d)(3) (or pledges or guarantees in respect of obligations of such persons), but only for CFCs for which an expatriated entity is a US shareholder, and then only for the 10-year inversion gain period of section 7874. For this purpose, a foreign related person is a foreign person that is related to or under common control with a US target in an acquisition to which section 7874 applies (or a US person related to said target). Generally, however, a foreign related person does not include an expatriated foreign subsidiary (i.e., a CFC with respect to which the US target or a related US person is a US shareholder), unless after the acquisition and related transactions the US target ceases to be a US shareholder with respect to that foreign subsidiary.

Section 956(e) authorizes regulations to prevent avoidance of section 956; however, as noted, section 956 also contains a specific list of investments over time decided by Congress to represent investments in US property. Thus, these regulations would represent an expansive reading of Congress' intent for anti-abuse regulations, so as to treat an investment in non-US property as "US property" without the need to trace a CFC's investment in such non-US property back to a US person (such as under a conduit arrangement).

Inversions and Business Integration

Generally, sections 367 and 1248 operate to allow for taxation of a CFC's untaxed earnings on various dispositions of shares in the CFC by a US shareholder. Using the authority under section 7701(l) (which addresses multiple party financing transactions), the Notice announced that Treasury and the IRS intend to issue regulations to prevent avoidance of sections 367 and 1248 by recharacterizing specified transactions. Generally, a specified transaction is one in which stock in an expatriated foreign subsidiary is transferred to a specified related person or a US target's share ownership in the expatriated foreign subsidiary is diluted. Again, an expatriated foreign subsidiary is defined as a CFC for which an expatriated entity is a US shareholder, and then only for the 10-year inversion gain period of section 7874. A specified related person generally is a foreign related person that is not a CFC of the US target, a US partnership that has one or more partners that is such a foreign person, or a US trust that has one or more beneficiaries that is such a foreign person.

Generally, a specified transaction is recast for all purposes of the Code such that the investment in stock of an expatriated foreign subsidiary by a specified related person is treated as having been transferred by that specified related person to the US shareholder(s) of the expatriated foreign subsidiary in exchange for stock issued by said US persons, and those US persons are in turn treated as transferring that property to the expatriated foreign subsidiary for stock. Generally, a specified transaction does not include transactions where the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and the US shareholder is required to recognize, and includes in income, proceeds as an actual or deemed gain or dividend. Further, generally, a specified transaction does not include a transaction where the expatriated foreign subsidiary is a CFC after it and all related transactions and the stock (by value) in the expatriated foreign subsidiary (and any lower tier expatriated foreign subsidiary) that is owned in aggregate by US shareholders does not decrease by more than 10% as a result of the specified transaction and any related transactions.

Congress enacted section 7701(l) in the wake of arrangements where three parties engaged in a chain of financing transactions (e.g., back to back loans from a Cayman company to a company resident in a country with a tax treaty with the United States and turn to a US company, in hopes of obtaining treaty benefits for payments from the US company). Congress specified that it intended to prevent tax avoidance by intermediate or conduit entities (even if not involving back to back loans). Thus, these regulations would represent an expansive reading of Congress' intent for section 7701(l), given their impact on the integration of business assets of a US target with a foreign acquirer (as opposed to shell intermediate companies), even when such arrangements do not include financing transactions.

The Notice also announced that Treasury and the IRS intend to issue regulations that would require an exchanging shareholder described in Treas. Reg. §1.367(b)-4(b)(1)(i)(A) (generally, a US person that is directly or indirectly a 10% shareholder by vote in respect of a foreign corporation that is exchanging said stock for stock in a foreign acquirer in an exchange described in section 351 or 354 or a foreign corporation that has such a US shareholder and makes such an exchange) to include as a deemed dividend the section 1248 amount attributable to stock of an expatriated foreign subsidiary transferred in the exchange, even when the requirements for non-inclusion under Treas. Reg. §1.367(b)-4(b) are otherwise satisfied. This would expand the reach of Treas. Reg. §1.367(b)-4. The Notice further announced that the future regulations will provide that the exceptions to subpart F foreign personal holding income treatment under Treas. Reg. §1.367(b)-4(c)(1) and for related party dividends under section 954(c)(3)(A)(i) and 954(c)(6) would not apply to the resulting deemed dividend of the section 1248 amount.

Section 304 Deemed Distributions

The Notice announced that Treasury and the IRS intend to issue regulations that would expand the scope of section 304(b)(5)(B) (relating to a foreign corporation's acquisition of stock in a related corporation). Generally, the rule prevents the acquisition of stock in a section 304 transaction resulting in a deemed dividend of the foreign acquirer corporation's earnings and profits of the transferor of the stock unless over 50% of any deemed dividend resulting from the acquisition is subject to US tax or includible in the earnings of a CFC. Under the authority of section 304(b)(5)(C), the Notice announced that future regulations will further enhance the section 304(b)(5)(B) limitation by providing that none of the foreign acquirer corporation's earnings and profits will be taken into account unless more than 50% of the section 304 deemed dividend is (i) sourced out of the earnings and profits of that foreign acquirer corporation and (ii) otherwise subject to US tax or included in the earnings and profits of a CFC (i.e., the earnings and profits of the issuing corporation are not to be taken into account for purposes of this 50% test). If the foreign acquirer corporation's earnings and profits are not taken into account under this enhanced section 304(b)(5)(B) limitation rule, the section 304 deemed dividend will then be sourced solely out of the earnings and profits of the issuing corporation. This enhanced section 304(b)(5)(B) limitation rule would apply to all section 304 transactions, regardless of whether related to or subsequent to an inversion subject to section 7874.

Given that Congress drafted section 304(b)(5)(B) so as to test for application to the "dividend" under the section 304(a) transaction "without regard to this subparagraph", these announced regulations represent an expansive reading of Congress' intent for regulations appropriate to carry out the purposes of section 304(b)(5)(B).

Effective Dates

The Notice announced the intent that future regulations issued thereunder apply to inversion transactions completed on or after September 22, 2014. However, the regulations under section 956 and 7701(l) only apply if the inversion transaction occurs on or after September 22, 2014, and the positions subject to those rules are also entered into or completed after that date.

Under the Notice, taxpayers may elect to apply to earlier periods the foreign-parented group exception for the carve back to the regulatory internal group restructuring exception.

Other Matters for Consideration: Earnings "Stripping" & Treaties

The Notice announced that Treasury and the IRS expect to issue additional guidance to limit inversion transactions contrary to the purposes of section 7874 and the benefits thereof. In particular, the Notice requests comments on guidance on cross-border investment and acquisitions that inappropriately shift or "strip" U.S. source earnings to lower-tax jurisdictions, including, but not limited to, intercompany debt. The Notice announced that such guidance will be prospective, except that for inverted groups such future guidance will apply to groups that completed inversion transactions on or after September 22, 2014. The authority to promulgate such possible regulations is unstated and unclear.

Finally, the Notice states that Treasury is "reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain treaty benefits that reduce U.S. withholding taxes on U.S. source income." Modifying treaties in respect of inverted companies, especially through regulations, would represent an expansive reading of Congress' intent for anti-abuse regulations given that Congress is given Constitutional power to ratify or refuse to ratify amendments to treaties or legislative overrides thereof.
