

PENN STATE LAW

CENTER FOR THE STUDY OF MERGERS
AND ACQUISITIONS

CROSS-BORDER M&A: INVERSION TRANSACTIONS

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Penn State Law – Center for the Study of Mergers & Acquisitions
An Introduction to Inversions
17 September 2014

LAST ONE OUT, PLEASE TURN OFF THE LIGHTS

The hottest dance move in Corporate America

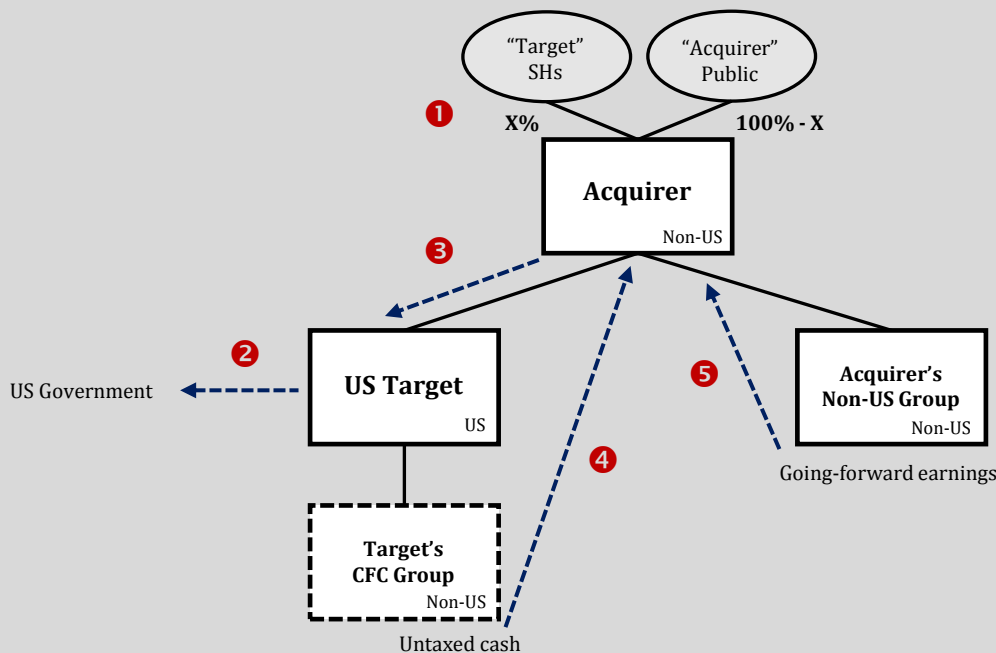
- Several mainline companies have inverted or are considering doing so (e.g., Pfizer, Chiquita, Eaton)
- SH groups have advanced the idea (e.g., Walgreens, Valeant)
- Do BODs have affirmative duty to explore?



Why do companies invert?

- Perception that US tax system is inhospitable to US MNEs
 - “Lock-out” effect vs. ability to tap foreign earnings immediately
 - 35% tax rate on WW income vs. lower headline rates and territorial systems
- Often immediately accretive to earnings *
- Globalization
- “Self-help” solution to political gridlock

POTENTIAL INVERSION BENEFITS

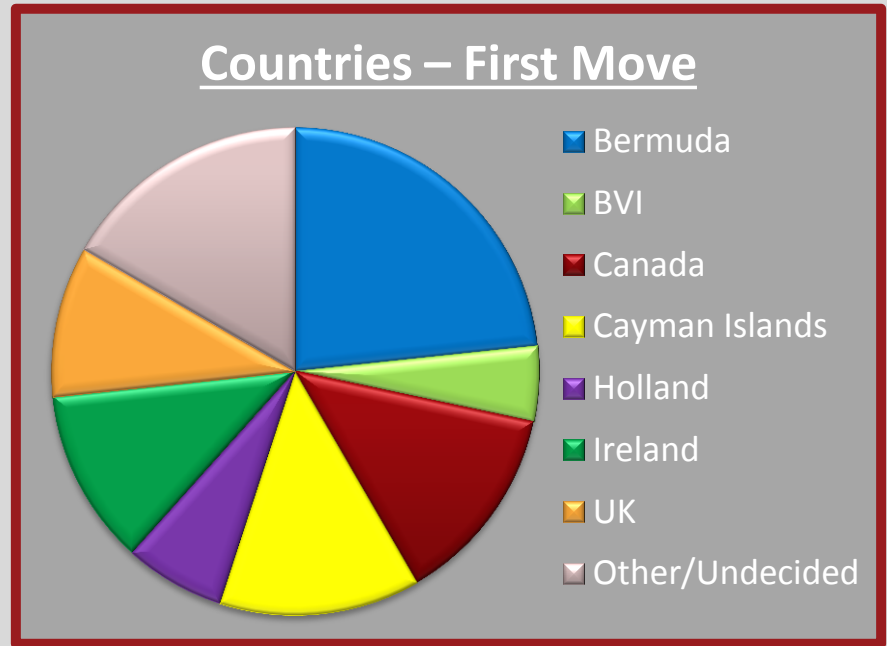
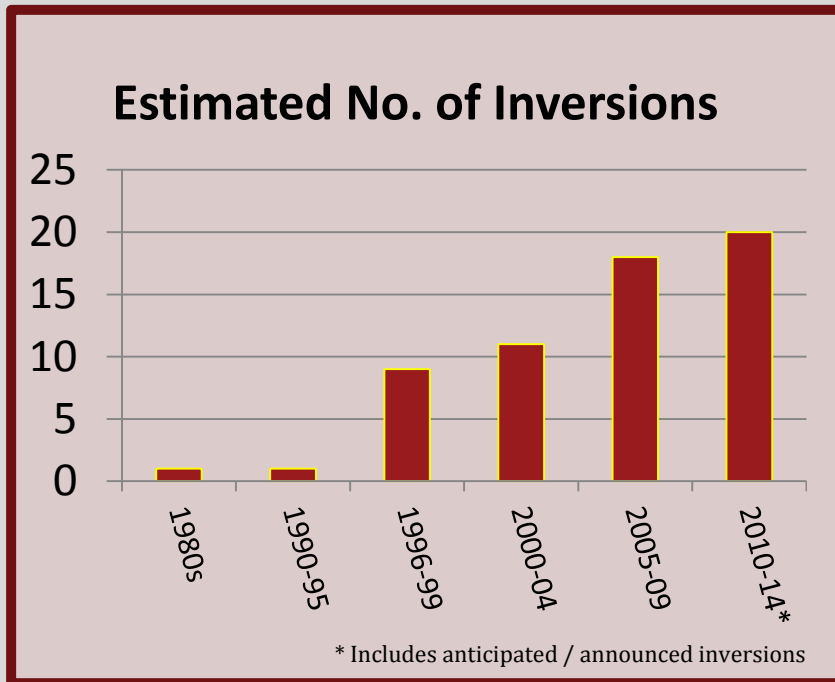


Key inversion-implicated benefits:

- 1 Ability to actually become foreign MNE (core)
- 2 Ability to contract with US government
- 3 Ability to lever-up taxable US operations
- 4 Ability to utilize US Target's "trapped" CFC cash
- 5 Ability to generate future earnings not subject to "lock-out" effect

INVERSION TRENDLINES

More than 50 companies have inverted or have plans to invert



Earlier period: Bermuda, Cayman Islands

More recently: Ireland, UK, Canada, Holland

GENERAL CHRONOLOGY

Historical Era	Notable Transactions	Government Responses
1980s	<ul style="list-style-type: none"> • McDermott (1983) 	<ul style="list-style-type: none"> • § 1248(i) enacted (1984)
Mid-1990s	<ul style="list-style-type: none"> • Helen of Troy (1994) • Tyco International (1997) • Fruit of the Loom (1998) 	<ul style="list-style-type: none"> • Notice 94-93 (regarding hook stock and <i>GU</i> repeal) • “Helen of Troy” regs issued (1994-96)
Late 1990s through Mid-2009	<ul style="list-style-type: none"> • Transocean (1999) • Seagate Technology (2000) • Ingersoll-Rand (2001) • Cooper Industries (2001) 	<ul style="list-style-type: none"> • § 7874 enacted (2004), significantly restricting opportunity for “self” inversions; testing involves, among others, a safe harbor and a facts/circ. test • § 4985 also enacted (2004) • § 457A also enacted (2008) • IRS removes § 7874 safe harbor (mid-2009)
Mid-2009 through mid-2012	<ul style="list-style-type: none"> • Biovail / Valeant (2010) • Aon (2012) • Sara Lee (2012) 	<ul style="list-style-type: none"> • IRS issues Notice 2009-78 (stock-counting) (late 2009) • IRS removes § 7874 facts/circ. test and imposes “bright line” 25% test (mid-2012)
Mid-2012 through Present	<ul style="list-style-type: none"> • Eaton / Cooper Industries (2012) • Liberty Global / Virgin Media (2013) • Actavis / Warner Chilcott (2013) • Perrigo / Elan (2013) • Applied Materials / Tokyo Electron (2014 – pending, to become <i>Eteris</i>) • Omnicom / Publicis (2014 – pending; aborted) • Chiquita / Fyffes (2014 – pending; Aug. 2014 Brazilian takeover rebuffed) • Pfizer / AstraZeneca (2014 – proposed; abandoned late May) • Walgreens / Alliance Boots (2014 – will proceed w/o inversion) • Medtronic / Covidien (June 2014 – proposed) • Monsanto / Syngenta (June 2014 – rumored, but apparently dead) • AbbVie / Shire (July 2014 – pending) • Salix / Cosmo (July 2014 – pending) • Mylan / Abbott Laboratories’s generics business (July 2014 – pending) • Allergan / Valeant (July 2014 – hostile takeover) • Burger King / Tim Hortons (August 2014 – inversion or merger of equals?) 	<ul style="list-style-type: none"> • IRS issues stock-counting regs (early 2014) • Obama FY15 budget proposals (March 2014) • IRS issues Notice 2014-32 (April 2014) • Flurry of inversion activity fails to ignite Hill action in direction of fundamental tax reform; instead, “targeted” inversion fixes (w/ potential retroactive effect) proposed; but seems Congress may not act quickly (May 2014) • Despite Hill rumblings, other companies suggest intention to do inversion-like business combinations (mid-2014) • Various legislative proposals, but parties seem to have difficulty reaching bipartisan agreement (September 2014)

THE EARLY DAYS

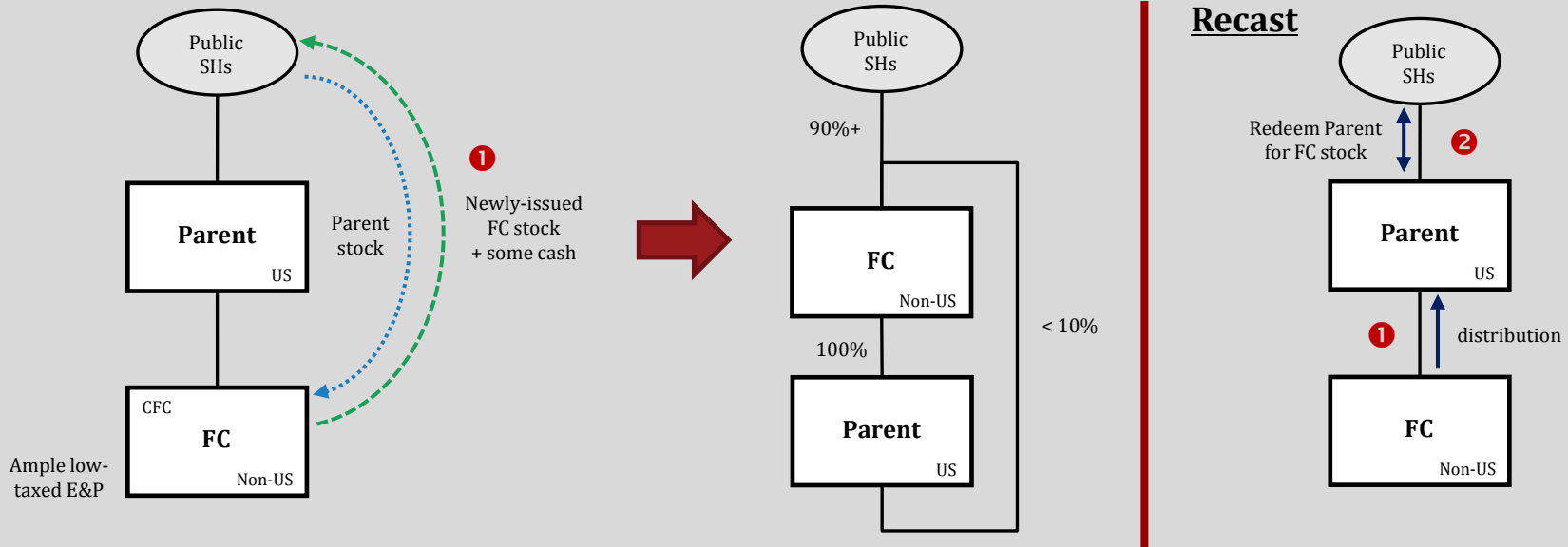
The 1980s

- McDermott's move to Panama triggered enactment of § 1248(i)
 - § 1248(i) essentially operates to preserve the “§ 1248 amount” by ensuring that US companies trigger § 1248 in inversions where a CFC tenders for the US company stock
 - Focuses on corporate-level taxation (targeting pick-up of untaxed E&P)

The 1990s

- Helen of Troy's move to Bermuda triggered promulgation of current Treas. Reg. § 1.367(a)-3(c)
 - Target's US SHs are generally taxed (despite non-recognition provisions) if (any):
 - (1) more than 50% of vote *or* value of new foreign parent's stock is received by US transferors in the transaction
 - (2) Foreign acquirer not engaged active foreign business for prior 3 years
 - (3) Foreign acquirer not worth at least as much as the US target
 - Focuses on shareholder-level taxation, with possible escape for true business deals

TRANSACTION TARGETED BY § 1248(i)



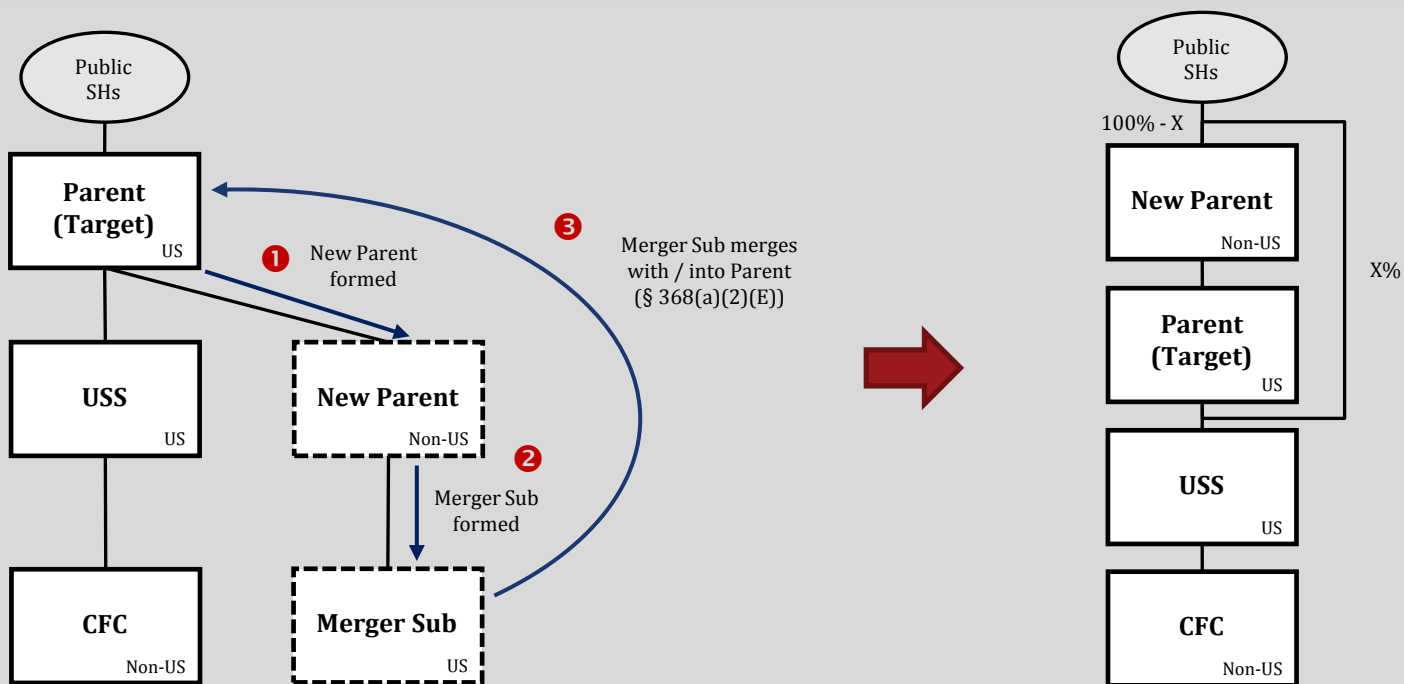
FC tenders for Parent stock

- FC is a CFC with ample cash and low-taxed E&P, and is unable to bring home cash to the US without significant residual US tax; thus, publicly-traded Parent sees to invert. FC tenders for 100% of the Parent stock, in exchange for newly-issued FC stock (representing 90%+ of FC stock) and a little cash; after transaction, FC is no longer a CFC
- IRS attempted to claim that these transactions involved a § 304 or a failed § 355, but the courts rejected that argument, so in 1984 Congress enacted § 1248(i)

Notes

- § 1248(i) Recast – seeks to preserve the “§ 1248 amount” by recasting the transaction as if:
 - FC had distributed its stock to Parent; and
 - Parent redeemed its stock for FC stock + cash
 As a result, Parent would trigger the application of § 1248(a) and be required to pick up deferred earnings of the CFC as dividend, to extent of gain
- McDermott

IMPETUS FOR HOT REGS



Internal reverse subsidiary merger (triangular)

- Parent (ultimately, Target) forms a non-US company (New Parent), which in turn forms a transitory US corp (Merger Sub) and contributes to it New Parent shares; Merger Sub then merges with / into Parent / Target and Public exchanges Parent shares for New Parent shares in a transaction qualifying as tax-free reorganization under § 368(a)(1)(A) / § 368(a)(2)(E)

Notes

- Reg. § 1.367(a)-3(c) – in combination with the “indirect” stock transfer rules, the HOT regs will cause Public SHs to be taxed on any gain in Parent stock if, e.g., those SHs collectively receive more than 50% of New Parent’s stock
- Sandwich structure requires “out-from-under” planning
- Helen of Troy; Cooper Industries

INTO THE NEW MILLENNIUM

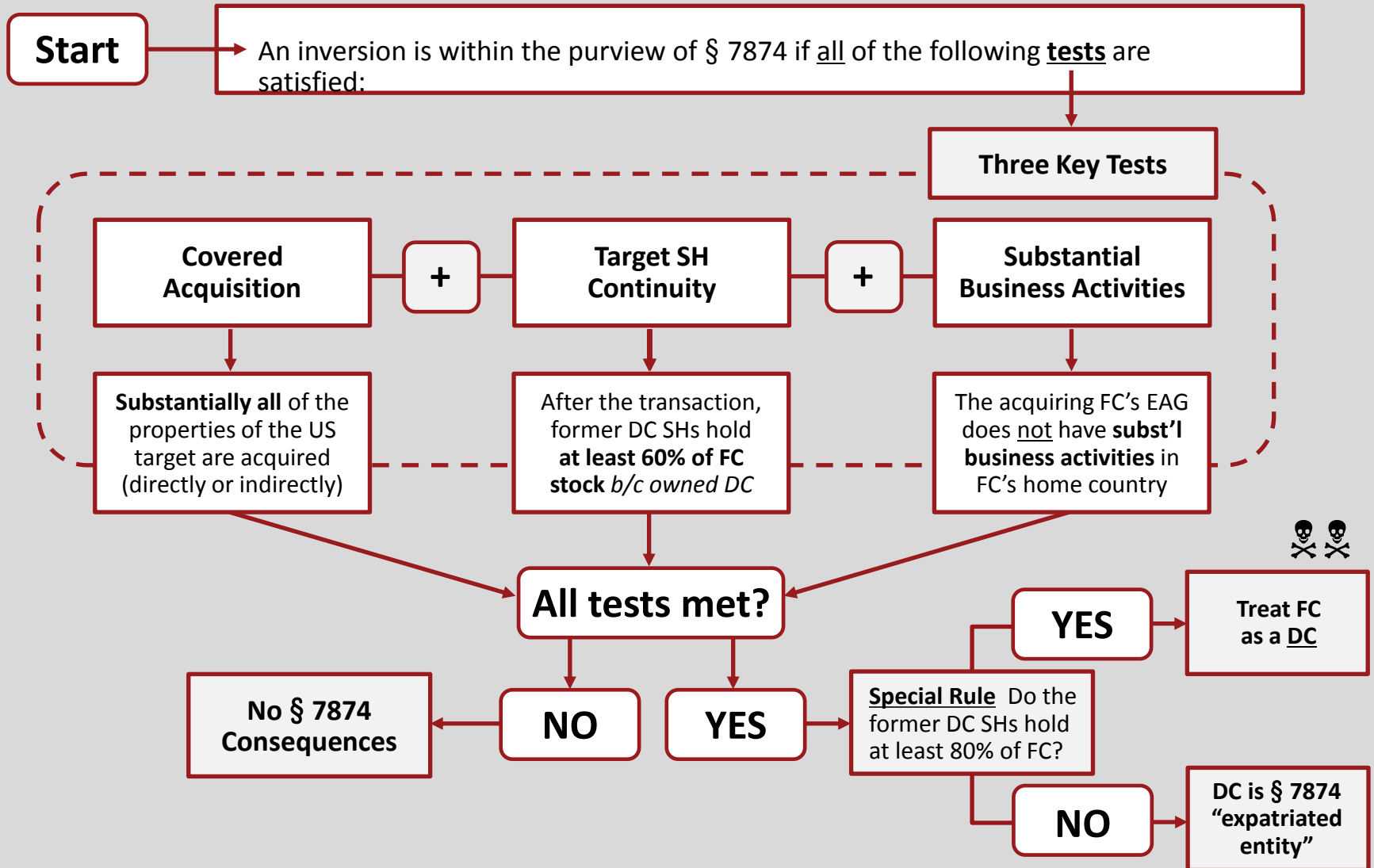
Y2K era / early 2000s

- Intensified era of inversion activity – favored destination was Bermuda or Cayman Islands
- HOT regs not viewed as serious impediment to inversions
- Post-9/11 – political rhetoric tied inversions to (lack of) patriotism, and Congress set “marker”

2004 and forward

- Congress adopted § 7874 and § 4985 in 2004
 - § 7874 essentially operates either to (1) fully-eliminate the consequences of an inversion, or (2) permit the inversion, but make post-inversion tax planning more difficult to achieve
 - Focuses on corporate-level taxation, with possible escape in certain cases
 - § 4985 imposes an excise tax on the stock compensation of officers, directors and major shareholders in a US company that inverts
 - Focuses on taxing executives and other persons responsible for the inversion
- Other post-2004 gov’t attempts to slow inversions (e.g., § 457A, reg. changes, Notice 2014-32)

§ 7874 STATUTORY FRAMEWORK



SUBSTANTIAL BUSINESS ACTIVITIES

Substantial business activities (SBA)

- **Statutory rule** – if, after the acquisition, the “expanded affiliated group” (EAG) to which the acquiring FC belongs has SBA in the FC’s “home” country (as compared to the EAG’s total business activities) then § 7874 does not present a problem
 - **EAG** – § 1504(a) definition, but includes foreign companies and ownership threshold is more than 50% vote and value
- **Current 25% test** – EAG has SBA in FC’s “home” country only if all the following are met:
 - **Group employees** – at least 25% of the EAG’s *number of employees* on the testing date are based in the country, and at least 25% of the *employee compensation* (all-encompassing, including employer-contributed payroll taxes) incurred by the EAG over the prior 12 months is to employees in such country
 - **Group assets** – at least 25% of the gross value of the EAG’s *tangible personal and real property* (incl. property rented from unrelated persons, valued at 8x net annual rent) is considered to have been physically present in the country over the prior 12 month period
 - **Group income** – at least 25% EAG’s gross income (arising from ordinary transactions with unrelated persons) over the prior 12 month period is derived from transactions with customers located in the country
- **Historic note** – until mid-2009, SBA used “dual approach” (i.e., facts / circ. approach and a 10% bright-line safe harbor); IRS removed 10% safe harbor in 2009, and in mid-2012 further modified the rules by removing facts / circ. approach and imposing 25% bright-line test (above)

OTHER § 7874 CONSIDERATIONS

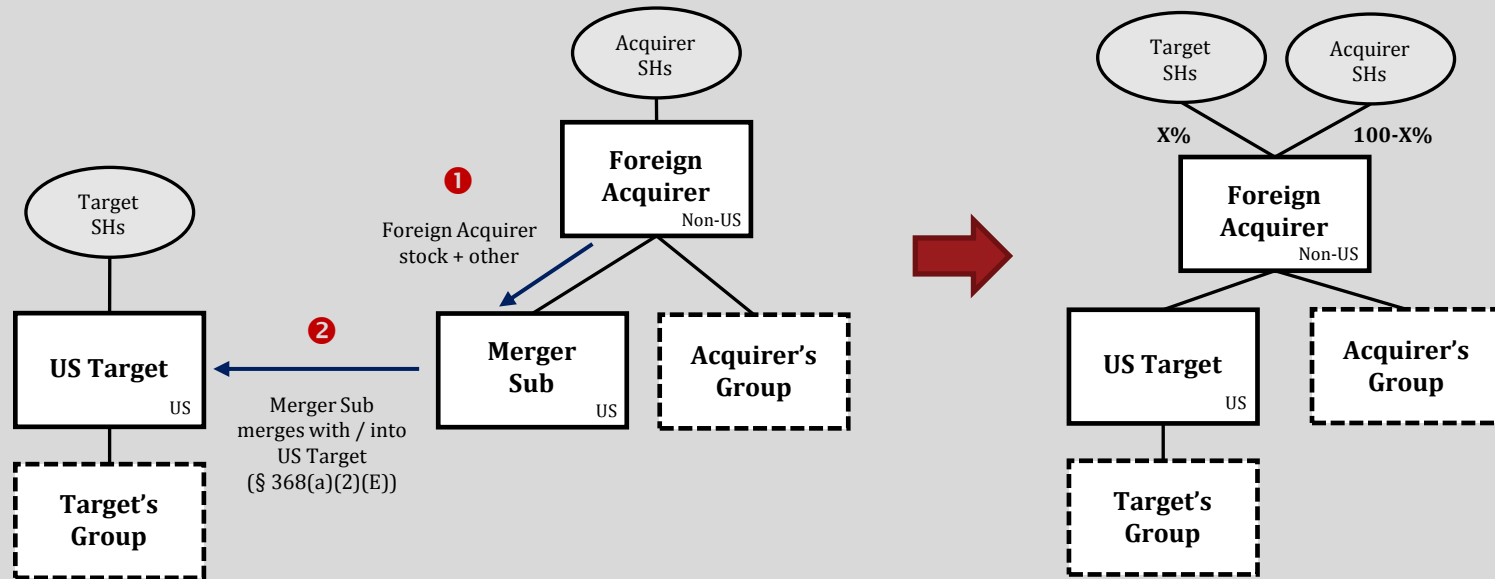
Shareholder continuity test

- **Statutory rule** – extent to which § 7874 applies (if at all) depends on percentage of acquirer FC stock held by US target SHs (by reason of owning target shares) after the transaction
 - **Key thresholds**
 - **< 60% (vote and value)** – § 7874 inapplicable
 - **60% to 79.99% (vote or value)** – target DC may be considered an “expatriated entity”
 - **80% + (vote or value)** – acquiring FC may be treated as a US corp. for US tax purposes
 - **Counting guidance** - the statute and regulations provide important guidance as to what goes into the numerator / denominator here (*i.e.*, stock to be “disregarded”); most recent set of regulations came out in January 2014

§ 7874 consequences

- **Expatriated entity** – the US target cannot utilize certain tax attributes (e.g., NOLs) to mitigate certain income or gain (e.g., due to out-from-under planning, etc.) for 10 years, etc.
- **80% threshold** – kiss of death

BASIC § 7874 TRANSACTION



Transaction overview

- *Regular reorg* – the basic reorganization rules are applicable for qualifying this transaction as a tax-neutral event; using a RSM gives more flexibility in terms of consideration, etc.
- *Resulting ownership is key* – the amount of SH continuity by the Target SHs ($X\%$) will determine the consequences of the transaction for both § 7874 and HOT reg purposes. See grid on following page. Generally, § 7874 is the focus; the HOT regs typically are not considered an impediment to doing the deal (unless, e.g., a founder SH exists)
 - *Focus on § 7874* – the corporate-level consequences vary depending on the size of $X\%$
 - $< 60\%$ (*vote and value*) – § 7874 not triggered
 - $60\% - 79.99\%$ (*vote or value*) – US Target is treated as an “expatriated entity” (e.g., certain income / gain of US Target for 10 years cannot be offset by NOLs) unless SBA found
 - $80\%+$ (*vote or value*) – Foreign Acquirer is treated as a US company (☠☠) unless SBA found

GRID – § 7874 / HOT REGS

High-level overview of inversion-like transaction consequences

Target SH Continuity	SH Level Consequences	Corporate Level Consequences
50% or less (vote and value)	SHs may not be taxed on gain ⁽¹⁾	N/A
50.01% to 59.99% (vote or value)	SHs generally taxed on gain	N/A
60% to 79.99% (vote or value)	SHs generally taxed on gain	DC treated as “expatriated entity” if no SBA
80% or more (vote or value)	SHs may be taxed on gain ⁽²⁾	Acquiring FC treated as DC if no SBA

⁽¹⁾ Depends on whether other requirements of HOT regs satisfied

⁽²⁾ Depends on treatment of FC

HAS GRIDLOCK CAUGHT UP WITH THE HILL?

Historically, companies wary of public and political outcry

- Most notably, early 2000s the Senate effectively instilled a moratorium
 - Stanley Works
- Congressional actions to limit gov't contracting by inverted companies



Photo via Office of Senator Wyden

By contrast, inversions today appear more compelling

- Political gridlock, and anti-business rhetoric on Hill and by NGOs, may have hardened resolve
- Deals are no longer just pure “tax moves”

Tax reform as a possible solution?

- Sen. Wyden (D-Oregon) calls inversions a “wake-up” call for tax reform
- IRS admits it is powerless to stop inversions



Photo via IRS

We've done, I think, probably all we can within the statute... We try to make sure people are within the bounds, but if they're within the bounds, if they play according to the rules, then they have a right to do that.

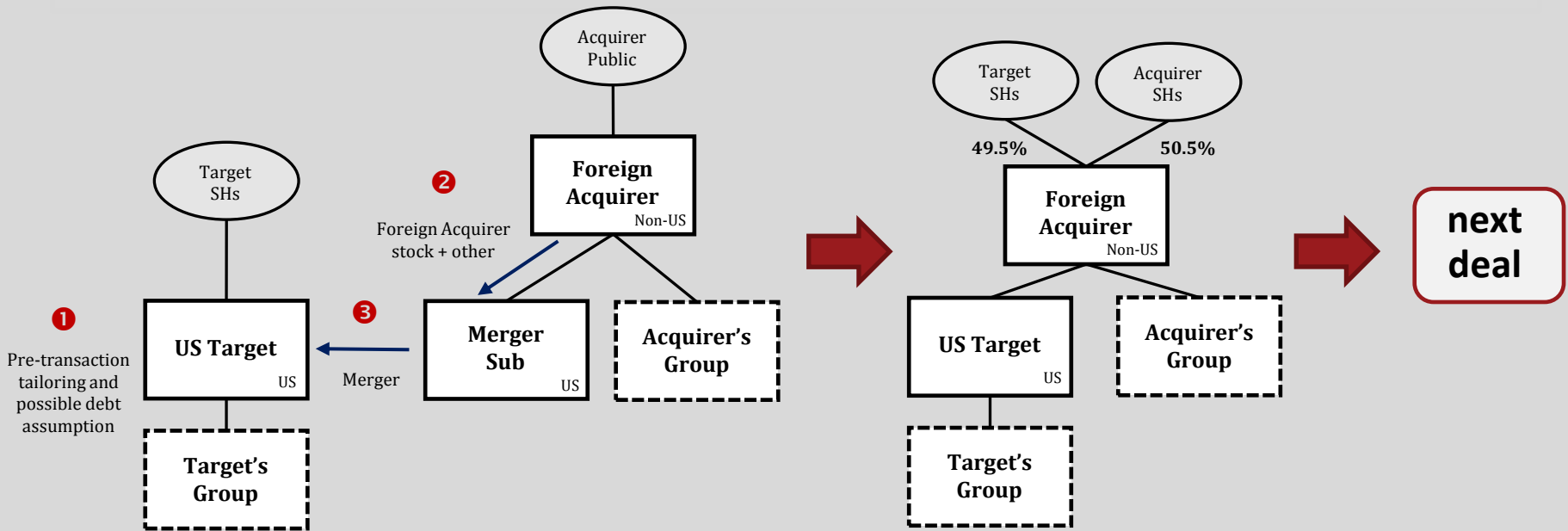
– John Koskinen, Commissioner, U.S. Internal Revenue Service
Capitol Hill (30 April 2014)

MODERN INVERSION TRANSACTIONS

Combination deals

- **Modern inversions are business deals** – it is not coincidental that the market has seen a rise in *combination deal* inversions (and a corresponding drop in *internal* inversions) since 2009, when the IRS started its regulatory tightening of the SBA rules; deal activity is escalating
 - **Ownership threshold focus** – today, modern deals focus on achieving levels of SH continuity that do not trigger adverse consequences under § 7874; accordingly, the primary focus today is on properly establishing the ownership threshold fraction, not SBA
 - **Unstoppable?** Because modern inversions are true *third-party deals* with non-tax synergies, query whether the gov't can effectively prevent US companies from inverting
- **Other regulatory snafus** – in addition, certain parties have found deficiencies in the IRS's highly-technical (*i.e.*, “Ph.D-level”) international M&A tax rules, delivering further inversion-related planning advantages (*e.g.*, turning off the HOT regs); the IRS has acted to shut down some techniques, but highly-technical rules often seem to lead to unforeseen consequences
- **Tax reform intersection** – several corporate executives have suggested that pursuing a combination inversion is more prudent than waiting for fundamental corporate tax reform from gridlocked legislative bodies

MODERN INVERSION TRANSACTION – EXAMPLE



General rules

- Similar to “basic” § 7874 deal noted earlier, but generally includes certain deal flourishes; prelude to future deals?
- *Era generally devoid of reliance on SBA*
- *Pre-txn tailoring* – this often serves important business purposes (e.g., restructure business lines, provide SHs a return on investment, etc.) and may also help achieve favorable post-combination results (e.g., leverage US ops, ensure § 7874 threshold not reached, etc.)
- *End result* – assuming the numbers work out correctly, it may be possible to avoid any § 7874 consequences (check stock ownership regs), avoid application of the HOT regs, and possibly insert debt into the US ops
- *Next deal?* – the first inversion creates a much larger company which may now have an enhanced ability to go after other US M&A targets without triggering negative inversion-related consequences for the US target SHs
- Biovail / Valeant / (Allergan?)



NOTICE 2014 - 32

NOTICE TARGETS INVERSIONS

Inversion transaction

- IRS identified certain inversion transactions where 2011 Killer B regs seemingly grant taxable US shareholders of target ability to avoid US tax on share gain by turning off § 367(a) rules (and thus the HOT regs). This would happen by *ensuring* that the 2011 Killer B regs would apply (i.e., not turned off under an exception or the priority rules), such that the § 367(a) rules would be turned off. IRS was also upset about the ability to easily lever up the US group via notes. Gov't says problems are with the no US tax exception, the priority rules and the anti-abuse rule, specifically:
 - **No US tax exception** – the 2011 Killer B rules would turn off if S is domestic and P is foreign and P would not be subject to US tax on an S dividend (including due to treaty relief). Some taxpayers took the view that P “theoretically” would be subject to tax if S actually had E&P (even though it had none presently) because, e.g., the treaty has > 0% dividend withholding rate. IRS says there must be more than “theoretical” tax possibility (i.e., S must actually have E&P); otherwise 2011 Killer B regs turn off under no US tax exception
 - **Priority rules** – the 2011 Killer B regs take precedence over the § 367(a) regs if the “§ 367(b) income” (defined as § 301(c)(1) and (c)(3) amounts) exceed the gain T’s SH’s would otherwise recognize under the § 367(a) rules (e.g., the HOT regs). The IRS was upset that the regulations failed to take into account that foreign persons normally are not subject to tax on capital gains; thus, IRS argues that “§ 367(b) income” should only include dividend income or gain that is subject to US tax (including via a subpart F inclusion)
 - **Anti-abuse rule** – taxpayers construing this too narrowly, (e.g., what constitutes a funding); also, rule can bring in T’s E&P even if T previously unrelated to P and S or newly-acquired in reorg

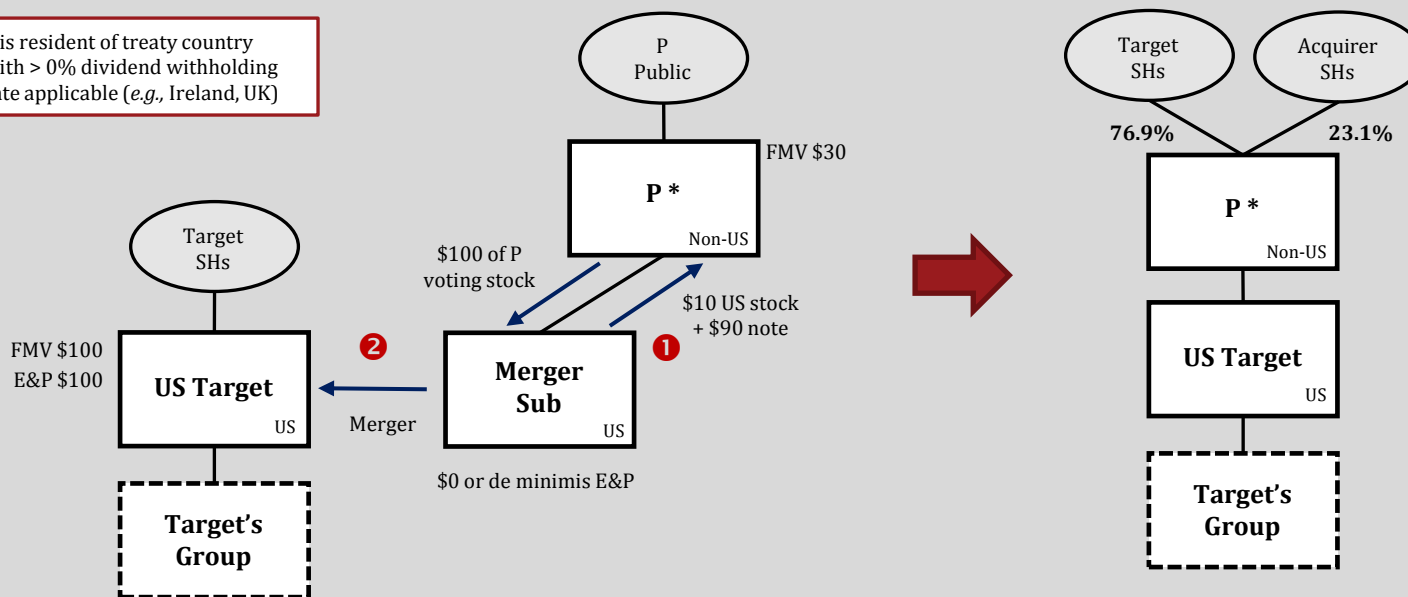
NOTICE TARGETS INVERSIONS (CONT.)

Notice-related changes impacting inversions

- **Exception and priority rule changes** – the following changes will be made:
 - **No US tax exception** – among other things, it will be modified such that, if P is a non-CFC foreign corporation and S is a domestic corporation, then the regs will “clarify” that it will apply (*i.e.*, the 2011 Killer B regs will be turned off) if a deemed distribution from S is *not* treated as a dividend subject to US tax (e.g., because of a treaty or because S has no E&P). Thus, HOT regs would remain on
 - **Priority rule definitions** – the definition of “§ 367(b) income” will be “modified” so that it will include § 301(c) dividend or gain only to the extent that US tax arises as a result of the distribution (including a subpart F inclusion). The net effect here is that the HOT regs are less likely to be turned off
- **Anti-abuse rule changes** – the following “clarifications” will be made:
 - **Use of a note** – to confirm that the use of a note by S to acquire P stock “may” trigger the anti-abuse rule; net effect here seems to be essentially targeting efforts within inversion transactions to lever-up the US without cost
 - **Funding timing** – funding of S may occur after the triangular reorganization, and that “funding” will include *loans, distributions, and capital contributions*. This dovetails well with the “use of a note” change noted above, and the net effect appears to be to broaden the opportunity for the IRS to attack inversion transactions (e.g., due to capital movements occurring *after* the fact); the *capital contribution* reference seems relevant to inversions; approach seems similar to that of Reg. § 1.304-4 and the § 956 anti-abuse rule
 - **E&P clarification** – revisions to the anti-abuse rule will be made to “clarify” that E&P of a corporation (including a successor) can be taken into account, *regardless of whether related to P or S before the reorg*; clearly inversion related

TARGETED INVERSION

* P is resident of treaty country with > 0% dividend withholding rate applicable (e.g., Ireland, UK)



Prior to notice

- *HOT regs* – even though Target SHs acquire more than 50% of P, Merger Sub's deemed distribution creates significant § 301(c)(1) and (c)(3) amounts such that HOT regs likely off under priority rules
- § 7874 – 80% threshold not breached, and may have SBA despite crossing 60% threshold
- *Leverage* – US company significantly leveraged

Post-notice treatment

- *Non-§ 7874 issues* – HOT regs likely remain on since P's § 301(c)(3) gain not subject to US tax (and dividend income, if any, unlikely to surpass Target SH's stock gain); if 2011 Killer B regs remain on (b/c some tax) then anti-abuse rule prob. picks up US Target's E&P to assess dividend
- § 7874 – same as prior to notice

FY 2015 BUDGET PROPOSAL: LOCK THE DOOR?

Proposal

- Changes § 7874 by eliminating the 60% test, and reduces the 80% test to greater than 50% test for shareholder continuity
- Adds an alternative “US nexus” test, wherein § 7874 would apply (*regardless* of shareholder-level continuity) if (1) the resulting company (foreign) is managed and controlled in the US, and (2) the EAG meets the SBA test in the US
- Foreign parent deemed to be US company for all US tax purposes
- Would apply to transactions that are completed post-Dec. 31, 2014

Potential targets

- Two US companies that set up new foreign holdco
- Foreign minnow that swallows a US whale
- Foreign whale presently run from US that acquires a US target



Photo by Pete Souza

Reason for change

US companies “have with greater frequency been combining with smaller foreign entities” and “emphasize that the US tax liability of the [MNE] is expected to be substantially reduced as a result of the transaction with only minimal changes to its operations.” Such transactions facilitate US-targeted BEPS such as US earnings-stripping (e.g., deductible payments by US subs to foreign affiliate), use of aggressive TP, and the potential loss of CFC status for foreign operations. No policy reason to permit inversions where (1) owners retain control of the resulting entity and minimal operational changes, or (2) the owners do not maintain control but EAG has “substantial business activities in the US” and parent managed/controlled in US.

See Treasury Green Book (March 2014)

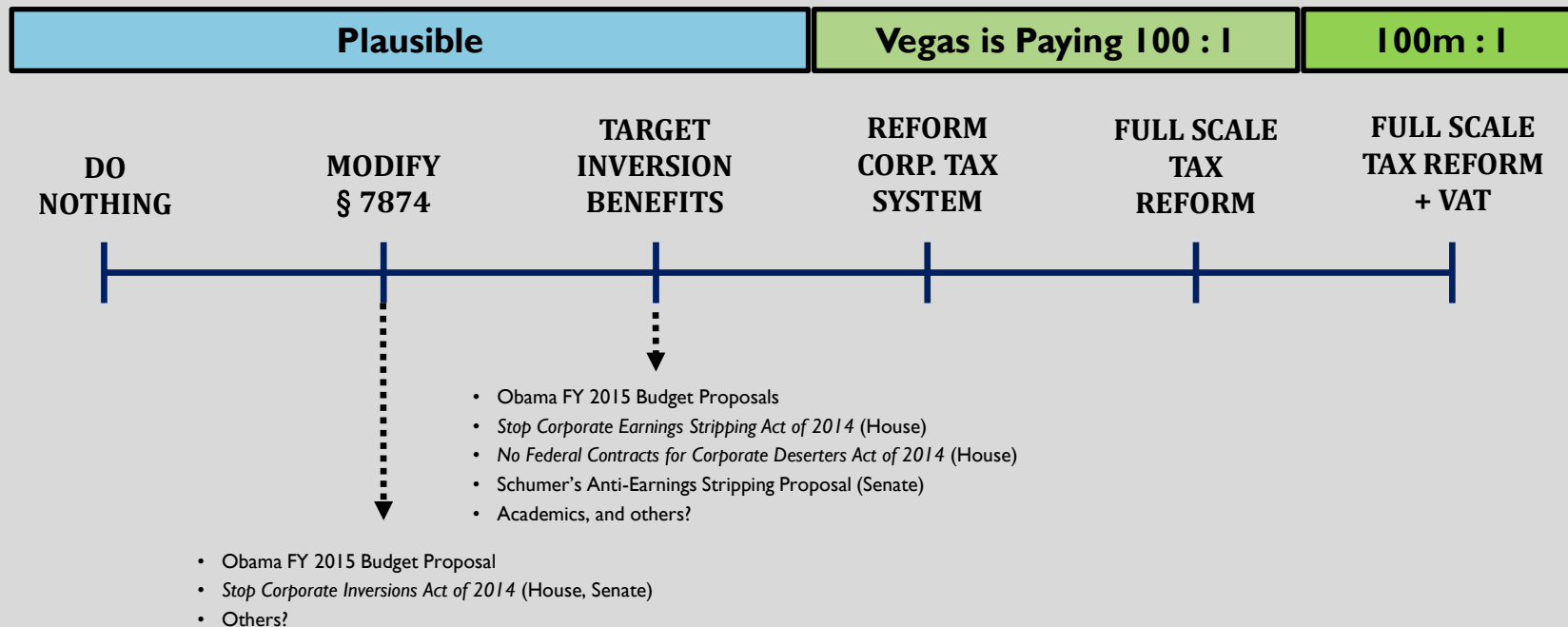


2014 – EVOLUTION OF ISSUES

2014 TIMELINE

- **April 26, 2014** – Pfizer approaches AstraZeneca
- **April 30, 2014** – IRS Com'r says “nothing IRS can do”
- **May 8, 2014** – the Levins announce inversion bill plans
- **May 9, 2014** – SFC Chair Wyden writes op-ed in *WSJ* saying “I don’t approach retroactivity in legislation lightly, but corporations must understand that they won’t profit from abandoning the US.”
- **May 20, 2014** – the Levins announce SCIA 2014, but at same time Wyden suggests would rather see inversions addressed as part of fundamental tax reform (but does believe in some 50% threshold test from May 8, 2014)
- **May 26, 2014** – Pfizer abandons bid for AstraZeneca presumably over price; may rebid in 6 months per UK)
- **June 15, 2014** – Medtronic announces Covidien deal (approx. \$43b cash/stock transaction). Agreement has provision that may call off deal if Congress passes anti-Inversion legislation. Rep. Levin indicates he will sit down with Medtronic to discuss “why they’re doing this...” and why the provision is in the agreement. A concern is Medtronic’s ability to claim US tax benefit (e.g., research credit) while headquartered in Ireland
- **July 14, 2014** – AbbVie succeeds in efforts (5th attempt) to convince Shire to combine forces. Shire is said to have resisted “law change” back-out provision (though reports are mixed here)
- **July 15, 2014** – Mylan revealed intent to acquire Abbott’s European generics drug business and invert to Holland. Treas. Secretary Jack Lew sends letter to Hill invoking need for “economic patriotism” and urging the Hill to take up anti-inversion action retroactive to May 2014
- **July 16, 2014** – Treas. Sec. Jack Lew comments that Treas. had scoured “obscure” tax provisions, would do more if it could
- **July 22, 2014** – SFC holds hearing on issue of US cos reincorp’g abroad. *The US Tax Code: Love It, Leave It or Reform It!*
- **July 26, 2014** – President Obama’s weekly address dedicated to the topic of inversions; notes that inversions are totally legal; further notes that “[t]he best way to level the playing field is through tax reform that lowers the corporate tax rate, closes wasteful loopholes, and simplifies the tax code for everybody.”
- **July 27, 2014** – Treas. Sec. Jack Lew writes op-ed in *Washington Post*, noting that since 1986 countries around the world have lowered their tax rates, leaving the US system with the highest rate and inefficient with lots of loopholes. Says that even while enacting comprehensive business tax reform is the best way to address issues that trigger inversions, suggests that there will always be a need to enact inversion provisions because there always will be near-0% rate jurisdictions
- **June 28, 2014** – Harvard Prof. Steven Shay article appears in *Tax Notes*
- **July 29, 2014** – *No Federal Contracts for Corporate Deserters Act* introduced
- **July 30, 2014** – *Stop Corporate Earnings Stripping Act* introduced
- **August 4, 2014** – Walgreens announces it is replacing its CFO
- **August 5, 2014** – Walgreens announces that it will not invert. Separately, the Treasury Department announces that it is considering *unilateral* steps to limit inversions, or meaningfully reduce the inversion-related tax benefits, if Congress does not act soon; Treasury is reviewing how it interprets existing laws and is considering a “partial fix” but will not announce details “in dribs and drabs.” In addition, Democratic Senators (Durbin, Reed, Warren) write to the Obama Administration urging the Administration to act on its on in respect of inversions
- **August 14, 2014** – Senator Schumer (D-New York) issues a press release outlining his inversion-related earnings stripping bill (similar to 2002 REPO Act)
- **September 10, 2014** – *Corporate Inverters Earnings Stripping Reform Act* introduced; SFC Chair Wyden indicates lots of interest in inversion-only bill (probably during lame-duck), and any responsible bipartisan bill needs to address earnings stripping
- **September 11, 2014** – Sen. Hatch reiterated interest in solving inversion issue by fundamental reform but open to initial stopgap effort provided (a) revenue neutral, (b) not retroactive, (c) advances tax reform effort, and (d) moves toward territorial. These four principles are “nonnegotiable”; predicts likely action during lame-duck
- **September 12, 2014** – Rep. S. Levin comments that Treasury action “may more than nibble around the edges” but “won’t get to the heart of the matter”

POTENTIAL DC RESPONSES TO “PROBLEM”



Note: We’ve been down this road before...

- Treasury subpart F study (2000)
- Treasury inversion study (2002)
- “Sense of Congress” (House 2003)
- Multiple § 163(j) proposals (e.g., S. 2119 (REPO))

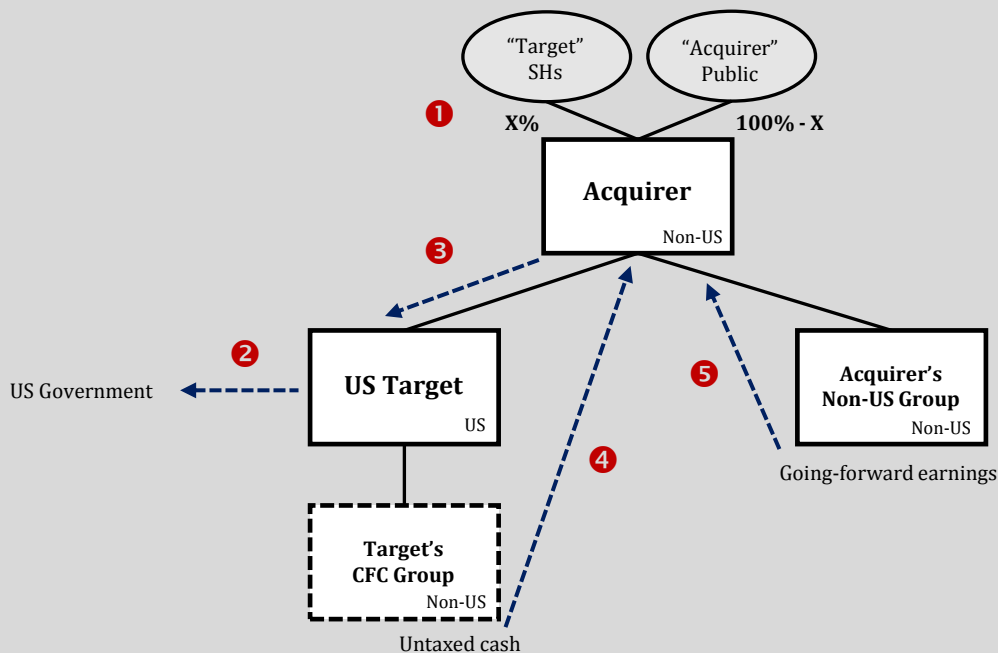
Both the recent inversion activity and the increase in foreign acquisitions of US [MNEs] are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for US businesses and the US economy. A comprehensive reexamination of the US international tax rules is needed. ... The reach of the various anti-deferral regimes, which can operate to impose current US tax on active business income earned abroad, should be reevaluated.

– *Corporate Inversion Transactions: Tax Policy Implications*, U.S. Treasury, May 17, 2002

It is the sense of Congress that passage of legislation to fix the underlying problems with our tax laws is essential and should occur as soon as possible, so United States corporations will not face the current pressures to engage in inversion transactions.

– H.R. 1308, § 103(b); passed by House on March 19, 2003 (108th Congress)

INVERSION BENEFITS REVISITED



Key inversion-implicated benefits:

- 1** Ability to actually become foreign MNE (core)
- 2** Ability to contract with US government
- 3** Ability to lever-up taxable US operations
- 4** Ability to utilize US Target's "trapped" CFC cash
- 5** Ability to generate future earnings not subject to "lock-out" effect

MISC. WAYS TO POTENTIALLY LIMIT BENEFITS

- *§ 163(j)*
- *Debt-Equity / § 385*
- *Conduit Financing Rules*
- *§ 956*
- *§ 482*
- *Subpart F*
- *§ 1248*
- *Increased Enforcement Activities*
- *Modifying Long-Standing Interpretative Approaches*
- *Others*

LEGIS. & ADMIN. PROPOSALS TO DATE

Obama FY 2015 Budget Proposal

- See prior slide

Stop Corporate Inversions Act 2014

- **Levin Brothers (D-Michigan)**
- **Two similar versions** – S. 2360 (2 year fix) and H.R. 4679 (permanent fix)
- **Alternate § 7874 tests** – treat as US company if either: (1) more than 50% SH continuity, or (2) EAG's management/control is *primarily* in US and significant US business activities (25% tests)
- **Out if group has SBA in foreign country**
- **Would be applicable from May 8, 2014**
- **Other issues**
 - **Management / control** – looks at EAG (not company), asks whether executives and senior management based or primarily located in US
 - **SBA exception** – 25% minimum threshold (can raise, not lower)
 - **Retroactivity** – grants Treasury § 7805(b) authority for retroactive regs (to May 8) and Treasury/IRS gets to decide!

Stop Corporate Earnings Stripping Act 2014

- **S. Levin (D-Michigan)**
- **Revises § 163(j)** – eliminates debt/equity safe harbor, reduce excess interest threshold to 25%, eliminate excess limitation carryforward and reduce disallowed amount carryforward to 5 years
- **Revises § 956** – makes it difficult to access CFC cash without inclusion
- **Placeholder for Treatment of “De-Controlled” CFCs**
- **Broad in scope** – targets all inbound companies, not just “inverters”; effective for years ending after enactment

No Federal Contracts for Corporate Deserters Act 2014

- **DeLauro (D-Connecticut), but bicameral**
- **Limits on ability of “inverter” groups to contract with US, but opportunity (limited) for waiver**
- **Wide reach** – possibly hits companies that inverted long ago (applicable to entity that completes before, on or after May 8, 2014 a transaction constituting an “inversion” under the 2014 Levin bills)

LEGIS. & ADMIN. PROPOSALS TO DATE (CONT.)

Corporate Inverters Earnings Stripping Reform Act 2014

- **Schumer (D-New York)** – similar to S. 2119 (REPO) proposal released by Grassley/Baucus in prior inversion era
- **Target’s EAGs containing “inverters”** (“applicable entity”)
 - **“Inverter”** – generally is **any** corporation that is a member of a EAG that includes a *newly-defined* SFC – i.e., a FC that is not a DC (due to the 80% test in § 7874) but that (1) acquires **before/on/after** March 4, 2003 substantially all of the properties of a DC/DP, and (2) is owned post-acquisition **more than 50%** by the domestic target’s SHs; for these purposes the SBA (foreign) exception to SFC status is irrelevant. This has an extremely broad reach...
- **For Inverters**
 - **§ 163(j) modifications** – for tax years of inverters (starting after enactment or becoming an inverter), will (1) remove the debt-to-equity safe harbor ratio, (2) reduce the interest expense deduction in a given year to 25% (rather than 50%) of “adjusted TI”, (3) eliminate the ability to use excess interest expense carryforwards, and (4) eliminate the ability to carry excess limitation forward
 - **Annual agreement requirement (10 years)** – inverters must file with Treasury/IRS an application for a pre-filing, advanced pricing or other similar agreement in respect of certain related-party transactions for the 10 taxable years starting with the first tax year in which the entity is an inverter
 - **Coverage** – intended to ensure that the requirements of §§ 163(j), 267(a)(3), 367, **482**, 845 and any other provision applicable to transactions between related parties are satisfied
 - **Failures** – a failure to file or properly complete the application will result in, in respect of transactions between the entity and a foreign related person, the (1) disallowance of items (e.g. of deductions, losses, additions to basis or COGS), (2) disregard of any transfer or license of a § 936(h)(3)(B) intangible, and (3) disregard of any cost-sharing arrangement
- **Effective date** – proposed to be effective for tax years after enactment

Treasury Guidance – TBD

SUMMARY OF POTENTIAL RESPONSES

Targeted Benefit	Potential Response	Comments
<p>Ability to invert via a transaction with a smaller foreign company, and yet continue US management</p>	<ul style="list-style-type: none"> • <u>Congress</u>. <i>Stop Corporate Inversions Act of 2014</i> by Levins (D-Michigan) (two similar bills but Senate proposal is only 2-year fix). Other bills may be put forward (e.g., Wyden?) • <u>Treasury</u>. Independent Treasury action seems unlikely, except possibly around the edges of current law 	<ul style="list-style-type: none"> • Obama's proposal is largely adopted by Levin bills • Levin bills both eliminate 60-80% concept, and instead treat FC as a DC if either (1) more than 50% SH continuity, or (2) the EAG's management and control is "primarily" in the US and the EAG has "significant domestic activities"; out if EAG has SBA in foreign country; there are many levers that make this difficult for taxpayers; both would apply with retroactive effect to May 8, 2014 though Senate version has sunset date two years out • Treasury might have limited ability to act in interpreting present § 7874
<p>Ability to contract with the government despite the "inversion."</p>	<ul style="list-style-type: none"> • <u>Congress</u>. <i>No Federal Contracts for Corporate Deserters Act of 2014</i> by Rep. DeLauro (D-Connecticut), w/ Rep. Doggett (D-Texas) and Senators C. Levin (D-Michigan) and D. Durbin (D-Illinois) • <u>Treasury</u>. Not an item of independent Treasury action 	<ul style="list-style-type: none"> • Makes it difficult for EAGs with "inverters" to be prime contractors (or even significant subcontractors) in re US gov't contracts; potentially applies to parties that have already inverted (statutory language suggests as much, but press releases muddy the water here), and ties definition to Levin bills
<p>Ability to reduce US tax on US operations</p>	<ul style="list-style-type: none"> • <u>Congress</u>. <i>Stop Corporate Earnings Stripping Act of 2014</i> by Rep. Levin (D-Michigan). <i>Corporate Inverters Earnings Stripping Reform Act of 2014</i> by Sen. Schumer (D-New York) • <u>Treasury</u>. Possibility for independent action under § 163(j), § 385, other provisions 	<ul style="list-style-type: none"> • Levin's bill would (1) eliminate debt/equity safe-harbor, (2) reduce excess interest expense threshold to 25%, (3) eliminate carryforwards of excess limitation (rather than current 3-year carryforward), and (4) restrict the carryforward of disallowed amounts to 5 years (vs unlimited today). Schumer's proposal (essentially the Grassley/Baucus 2002 REPO bill) would mirror the Levin bill, except that his bill would (a) fully eliminate the ability to carryforward disallowed amounts, (b) require the US sub to annually obtain pre-approval of the terms of related-party transactions for 10 years following the inversion, and (c) apply only to "inverters" (broadly defined) • Treasury may come out with a notice targeting debt/equity (§ 385) and possibly interest-expense (e.g., § 163(j)); the notice breadth is unclear
<p>Ability to utilize "trapped" CFC cash for post-transaction matters</p>	<ul style="list-style-type: none"> • <u>Congress</u>. <i>Stop Corporate Earnings Stripping Act of 2014</i> by Rep. Levin (D-Michigan) • <u>Treasury</u>. Possibility for independent action under § 956, conduit financing regulations, etc. 	<ul style="list-style-type: none"> • Levin's bill would modify § 956 so that for EAGs with a foreign parent (1) investments by a CFC in "foreign group property" (essentially stock of debt in a foreign related party that is not a CFC, with some exceptions) triggers inclusions, and (2) Treasury can write regulations treating a CFC as holding an obligation of a foreign related party if the CFC (or US shareholder thereof) is a pledgor or guarantor of the obligation • Treasury may come out with a notice targeting use of CFC cash; the notice breadth is unclear
<p>Ability to generate earnings going-forward not subject to "lock-out" effect</p>	<ul style="list-style-type: none"> • <u>Congress</u>. <i>Stop Corporate Earnings Stripping Act of 2014</i> by Rep. Levin (D-Michigan) • <u>Treasury</u>. Possibility for independent action 	<ul style="list-style-type: none"> • Levin's bill currently contains only a placeholder for "de-controlling" CFCs; thus, it is unclear which provisions may be targeted • Treasury may come out with a notice targeting de-controlling or out-from-under planning; the notice breadth is unclear



THANK YOU...

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Brian regularly speaks at events sponsored by TEI (where he previously served as Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

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