New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer

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This report argues that the new inversions many U.S. corporations are engaging in are giving the "Killer B" regulations a Joe Frazier left hook, even after the issuance of Notice 2014-32. It suggests ways Treasury and Congress can fight back against these transactions, particularly in view of the recently announced Pfizer inversion, which would have been the largest of its type.

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I. Introduction

In the first match between Joe Frazier and Muhammad Ali, Frazier's unexpected left hook knocked Ali to the canvas and Frazier won the fight. Taxpayers have delivered the government a Frazier left hook: using the section 367(b) priority rule in the "Killer B" regulations[1] to avoid having their shareholders taxed under section 367(a) in some triangular reorganizations.

Treasury fought back April 25 with the issuance of Notice 2014-32, 2014-20 IRB 1006. The notice is designed to prevent new types of inversions by eliminating the deemed contribution rule in the regulations.

As discussed below, Notice 2014-32 weakens the left hook but doesn't block it. In fact, three days after the notice was released, Pfizer Inc. announced its proposed inversion, which would have been the largest of its type. This report examines the tools available to Treasury and Congress to battle new inversions by completely disabling the Frazier left hook.

II. The Government's Fight Against Inversions

In inversion transactions, a U.S. corporation becomes a subsidiary of a foreign holding company. The transactions have two basic purposes: (1) to avoid the U.S. controlled foreign corporation provisions by having foreign operations conducted through foreign subsidiaries of the foreign holding company rather than foreign subsidiaries of the U.S. corporation; and (2) to establish a structure that will facilitate interest stripping by having the foreign

[1]Reg. section 1.367(b)-10(a)(2)(iii); T.D. 9526.

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holding company or one of its foreign subsidiaries hold debt issued by the U.S. corporation.[2]

Treasury has fought inversions principally through the regulations under section 367(a), which apply a gain recognition rule if the shareholders of a U.S. corporation participating in an inversion end up with more than 50 percent of the stock of the foreign holding company.

Congress has fought inversions through the enactment of section 7874 in 2004.[3] The statute applies the following two anti-inversion rules:

1. If the shareholders of the U.S. corporation end up with 80 percent or more of the stock of the foreign holding company, the holding company is treated as a U.S. corporation. This treatment defeats avoidance of the CFC provisions and deters interest stripping.

2. If the shareholders of the U.S. corporation end up with 60 percent or more but less than 80 percent of the foreign holding company, an inversion gain rule applies that prevents the U.S. corporation from using losses to offset inversion gain, such as gain arising on a sale of one of the U.S. corporation's CFCs to the foreign holding company.

As a result of the interface with section 7874, the section 367(a)(1) gain recognition rule applies if the shareholders of the U.S. corporation end up with more than 50 percent but less than 80 percent of the stock of the foreign holding company. The following table summarizes the various rules:

Percentage of Foreign Holding Company Stock Held by Shareholders of U.S. Corporation	Applicable Rules
51 percent through 59 percent	section 367(a) gain recognition rule
60 percent through 79 percent	section 367(a) gain recognition rule and the section 7874 inversion gain rule
80 percent or more	the foreign holding company is treated as a U.S. corporation

III. New Inversions

Despite the section 367(a)(1) gain recognition rule and section 7874, several U.S. corporations have recently engaged in inversion transactions.[4] These new inversions involve the combination of a U.S. corporation (the actual acquirer) with a foreign corporation (the target). The combination is accomplished through a reorganization in which both the U.S. and foreign corporations become subsidiaries of a newly formed foreign holding company. In the old inversions, by contrast, a newly formed foreign holding company would ultimately own only a real U.S. corporation.

Two examples of new inversions are (1) the combination of Endo Health Solutions, a publicly held U.S. corporation, with Paladin Labs Inc., a publicly held Canadian corporation; and (2) the combination of Applied Materials, a publicly held U.S. corporation, with Tokyo Electron Ltd., a publicly held Japanese corporation. In the Endo transaction, Endo and Paladin were acquired by a newly formed Irish holding corporation. In the Applied Materials transaction, Applied Materials and Tokyo Electron were acquired by a newly formed Netherlands holding company. This report focuses on the Endo transaction.

IV. The Endo Transaction

A. Basic Structure of the Inversion

The combination agreement in the Endo inversion[5] provides for a newly formed Irish holding company (IrishCo aka New Endo) to (1) acquire Paladin under a Canadian law ''arrangement''; and (2) acquire Endo through a triangular B reorganization under section 368(a)(1)(B).

The arrangement set out in section 2.1 of the agreement is similar to the arrangement under U.K. law used by GE in its acquisition of Amersham.[6] Under the Canadian law arrangement, the public shareholders of Paladin receive approximately 23 percent of the stock of New Endo.

The triangular B reorganization is implemented by section 2.2 of the agreement, titled ''Merger.'' Under this provision, Endo's stock is acquired by Endo U.S. Inc., a Delaware corporation and wholly owned subsidiary of New Endo. Endo U.S. Inc. issues its promissory note in exchange for the stock. The acquisition of Endo by Endo U.S. Inc. is accomplished through a reverse subsidiary merger in

[2]For a discussion of inversions and related issues, see Samuel C. Thompson Jr., *Mergers, Acquisitions and Tender Offers*, ch. 22 (May 2014 ed.).

[3]For a background discussion on the inversions before the enactment of section 7874, see Thompson, ''Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions,'' *Tax Notes*, Mar. 18, 2002, p. 1505.

[4]Lee A. Sheppard, ''Inversions Continue, but Are More Difficult,'' *Tax Notes*, Oct. 28, 2013, p. 355.

[5]Appendix 22C of Thompson, *supra* note 2, contains excerpts from the following documents used in the Endo transaction: (1) the arrangement agreement, which was entered into November 5, 2013; and (2) the proxy/prospectus on Form S-4, which was issued January 24, 2014.

[6]*See* section 20:6.4 and Appendix 20B of Thompson, *supra* note 2.

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which Merger Sub, a Delaware limited liability company wholly owned by Endo U.S. Inc., merges into Endo. The public shareholders of Endo receive voting shares of New Endo for their Endo stock, and Endo U.S. Inc. holds all the Endo shares.

When the dust settles on the Endo side of the transaction, Endo becomes a wholly owned subsidiary of Endo U.S. Inc., which is a wholly owned subsidiary of New Endo, the Irish holding company. Also, Endo's public shareholders end up owning approximately 77 percent of the New Endo stock. The transaction presumably qualifies as a triangular B reorganization because the consideration paid by Endo U.S. Inc. in the merger of Merger Sub into Endo is solely voting stock of New Endo, the parent of Endo U.S. Inc.

The Endo proxy/prospectus gives the following reasons for incorporating the holding company in Ireland:

A	Incorporating New Endo in Ireland is expected to result in significant benefits to New Endo. These benefits include enhanced global cash management flexibility and associated financial benefits to the combined enterprise (*e.g.*, interest stripping), as well as increased global liquidity and cash flow among the various entities of the combined enterprise. In addition, Ireland is a beneficial location for establishing a differentiated platform for further international expansion through an operating base in Ireland and a strong financial profile to support expansion into international markets (*i.e.*, avoidance of the CFC provisions). Also, Endo estimates that New Endo is expected to realize $75 million of post-tax synergies on a 12-month basis at some point following the close of the transactions.
See Section III.A.1 of Appendix 22C of Thompson, *supra* note 1.	

B. Issues Under Sections 7874 and 367(a)

1. The relationship between sections 367(a) and 367(b). Under section 367(a), which deals with outbound reorganizations and other tax-free outbound transactions, gain is recognized except when the regulations provide otherwise. Under section 367(b), which deals with non-outbound reorganizations and some other tax-free non-outbound transactions, gain is not recognized unless specifically provided in the regulations.

2. Will section 7874 treat New Endo as a domestic corporation? The first question under section 7874 is whether New Endo should be treated as a U.S. corporation. It should not, because the Endo shareholders receive less than 80 percent of the stock of New Endo.

In discussing this issue, the Endo proxy/prospectus observes that based on some factual assumptions and the rules for determining stock ownership under section 7874, Endo shareholders are expected to be treated as holding less than 80 percent (by both vote and value) of the New Endo ordinary shares after the merger because of their ownership of Endo common stock. However, it cautions that ''whether the ownership test has been satisfied must be finally determined after the closing of the merger, by which time there could be adverse changes to the relevant facts and circumstances.'' The proxy/prospectus also notes that Endo's obligation to effect the transactions is conditioned on a favorable opinion from Skadden, Arps, Slate, Meagher & Flom LLP that section 7874 shouldn't apply to cause New Endo to be treated as a U.S. corporation from and after the closing date.[7]

3. How does the section 7874 inversion gain rule apply? The second consideration under section 7874 is the inversion gain rule, which applies because the Endo shareholders end up with at least 60 percent but less than 80 percent of the shares of New Endo. The Endo proxy/prospectus discusses this issue:

> Pursuant to the arrangement agreement, the Endo shareholders are expected to receive at least 60 percent (but less than 80 percent) of the vote and value of the New Endo ordinary shares by reason of holding Endo common stock. As a result, Endo and its U.S. affiliates would be limited in their ability to utilize certain U.S. tax attributes to offset their inversion gain, if any. However, neither Endo nor its U.S. affiliates expects to recognize any inversion gain as part of the merger, nor do they currently intend to engage in any transaction in the near future that would generate inversion gain. If, however, Endo or its U.S. affiliates were to engage in any transaction that would generate any inversion gain in the future, such transaction may be fully taxable to Endo or its U.S. affiliates (notwithstanding that it may have certain deductions and other U.S. tax attributes which, but for the application of Section 7874, it would be able to use to offset some or all of such gain) and thus Endo may pay U.S. federal income tax sooner than it otherwise would have.[8]

This statement suggests that Endo does not plan to transfer stock of any of its CFCs to New Endo, because those transfers would produce inversion gain if the CFC stock has appreciated. New Endo could presumably conduct any additional non-Irish business through subsidiaries of New Endo that

[7]*See* Section III.C.2.b of Appendix 22C of Thompson, *supra* note 2.

[8]*Id.* at Section III.C.2.c of Appendix 22C.

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were not also subsidiaries of Endo. Those subsidiaries would not be subject to the U.S. CFC provisions.

4. How does the section 367(a)(1) gain recognition rule apply? As noted earlier, the regulations under section 367(a)(1) provide for gain but not loss recognition on any outbound reorganization like the Endo transaction if the shareholders of the U.S. corporation end up with more than 50 percent of the stock of the foreign corporation. Even if the 50 percent condition is not satisfied, any shareholder with more than 5 percent of stock recognizes gain unless the shareholder enters into a gain recognition agreement.

In discussing the general gain recognition rule under section 367(a)(1), the proxy/prospectus notes that Endo expects to receive from Skadden (but doesn't condition the merger on) an opinion that the merger should qualify as a reorganization under section 368(a). Presumably, Skadden would express the view that the reverse subsidiary merger is a triangular B reorganization. The proxy/prospectus says that under section 367(a) and its regulations, absent an applicable exception, U.S. holders of Endo common stock will be required to recognize gain (but not loss) on their exchange of Endo common stock for New Endo ordinary shares in the merger in an amount equal to the excess of the fair market value of the New Endo ordinary shares received over the adjusted tax basis of the Endo common stock exchanged therefor.[9]

V. The Frazier Left Hook to Section 367(a)(1)

A. Introduction

Embedded in the Endo transaction is a Frazier left hook designed to knock out the section 367(a)(1) gain recognition rule and set up an interest stripping transaction. To understand why this is a Frazier left hook, one must appreciate Treasury's concern about the Killer B transaction, which was principally designed to avoid U.S. tax on the repatriation of foreign income that had been deferred from U.S. tax.

B. The Prototypical 'Repatriation Killer B'

The IRS first expressed concern about the Killer B transaction in Notice 2006-85, 2006-2 C.B. 677.[10] The notice was directed primarily at the use of a triangular B reorganization to avoid what would otherwise be a taxable repatriation of income from a foreign subsidiary.

The notice described a typical tax-free repatriation transaction as one involving a domestic parent (P) with a foreign subsidiary (S), a domestic subsidiary (S1), and a second-tier foreign subsidiary (T) through S1. In a triangular B reorganization, S purchases P stock for cash or a note and provides the P stock to S1 in exchange for all the T stock. Taxpayers maintain that (1) P recognizes no gain or loss under section 1032 on the sale of its stock to S for cash or a note; (2) S takes a cost basis in the P shares under section 1012; and (3) S recognizes no gain under reg. section 1.1032-2(c) on the transfer of the P shares immediately thereafter because the basis and FMV of the shares are equal. The notice continues:

> Thus, taxpayers take the position that the cash or note used by S to acquire the P stock does not result in a distribution under section 301. Furthermore, taxpayers do not include in income amounts under section 951(a)(1)(B) because S acquires and disposes of the P stock before the close of a quarter of the taxable year, which is the time at which to measure P's share of the average amount of United States property held by S. See section 956(a)(1)(A). Finally, under section 1.367(b)-4(b)(1)(ii), S1 does not include in income as a deemed dividend the section 1248 amount attributable to the T stock that S1 exchanges.

In this transaction, the domestic parent receives cash from a CFC in what amounts to a tax-free repatriation transaction (repatriation Killer Bs). This isn't the case in the Endo transaction, which involves a foreign parent corporation.

C. The 'No-Withholding and Stripping' Killer B

Notice 2006-85 also expressed concern about possible avoidance of the U.S. gross basis tax (that is, withholding tax on dividends paid to foreign persons) and interest stripping through the use of a Killer B transaction in which the parent is a foreign corporation:

> Where P is foreign and S is domestic, the transaction could have the effect of repatriating S's U.S. earnings to its foreign parent in a manner that is not subject to U.S. withholding tax. This variation of the transaction also raises U.S. earnings stripping issues where S uses a note to purchase all or a portion of the P stock.

The specific concern is with the use of a Killer B transaction to (1) avoid the gross basis withholding tax on the payment of what would otherwise be a dividend from the U.S. subsidiary to its foreign parent, and (2) facilitate interest stripping through interest payments by the U.S. subsidiary to the foreign parent on the note the subsidiary gives to the parent in exchange for the parent's stock. These

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[9] *Id.* at Section III.C.2.d of Appendix 22C.

[10] For a recent discussion of Killer Bs, see Jasper L. Cummings, Jr., "'Killer B' and Tax Policy," *Tax Notes*, Jan. 20, 2014, p. 343.

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no-withholding and stripping Killer Bs are at issue in the Endo inversion because, in the absence of regulations, there would be no gross basis tax on Endo U.S. Inc.'s purchase of the New Endo stock, and the note issued by Endo U.S. Inc. to New Endo would facilitate interest stripping from the United States.

D. The Section 367(b) Regs and Notice 2014-32

1. The general distribution rule. On June 13, 2011, Treasury issued the Killer B regulations. These regulations, which are principally set out in reg. section 1.367(b)-10, address both the repatriation Killer B transaction and the no-withholding and stripping Killer B. This section examines those regulations as originally promulgated and as modified by Notice 2014-32.

The scope of the regulations is described in reg. section 1.367(b)-10(a)(1), which, subject to three exceptions discussed below, provides:

> This section applies to a triangular reorganization if P or S (or both) is a foreign corporation and, in connection with the reorganization, S acquires in exchange for property all or a portion of the P stock or P securities (P acquisition) that are used to acquire the stock, securities or property of T in the triangular reorganization.

Thus, the regulations apply to both the repatriation Killer B, in which the parent is a domestic corporation and the subsidiary is a foreign corporation, and the no-withholding and stripping Killer B, in which the parent is a foreign corporation and the subsidiary is a domestic corporation.

When the regulation applies, reg. section 1.367(b)-10(b) (before the issuance of Notice 2014-32) converts the purchase of the parent's stock into a deemed distribution by the subsidiary and a deemed contribution by the parent:

> (1) Deemed distribution. If this section applies, adjustments shall be made that have the effect of a distribution of property (with no built-in gain or loss) from S to P under section 301 (deemed distribution). The amount of the deemed distribution shall equal the sum of the amount of money transferred by S . . . and the fair market value of other property transferred by S in the P acquisition in exchange for the P stock . . . received by T shareholders . . . in [a reorganization] exchange. . . .
>
> (2) Deemed contribution. If this section applies, adjustments shall be made that have the effect of a contribution of property (with no built-in gain or loss) by P to S in an amount equal to the amount of the deemed distribution from S to P under paragraph (b)(1) of this section (deemed contribution).

Notice 2014-32 says that the deemed contribution rule will be removed and that conforming changes will be made to the regulations. Thus, although the deemed distribution continues after Notice 2014-32, the deemed contribution, which could increase the parent's basis in the subsidiary's stock in the amount of the deemed dividend, has been removed.

Under the general distribution rule, which is unchanged by Notice 2014-32, the foreign subsidiary's purchase of the domestic parent's stock in a repatriation Killer B transaction is treated as a distribution by the subsidiary to the parent. Thus, the distribution is a repatriation of the subsidiary's deferred income. In a no-withholding and stripping Killer B, the note transferred by the domestic subsidiary to the foreign parent is treated as a distribution by the subsidiary to the parent. To the extent the distribution is out of earnings and profits and is therefore a dividend, it will be subject to the gross basis tax subject to reduction by tax treaty.

2. Exceptions to the general rule. Reg. section 1.367(b)-10(a)(2) provides that the section 367(b) regulations and the deemed distribution do not apply to the following three situations:

> (i) the parent and subsidiary are foreign corporations, and neither of them are CFCs;
>
> (ii) the subsidiary is a domestic corporation, the parent's stock in the subsidiary is not a U.S. real property interest (within the meaning of section 897(c)), and the parent would not be subject to U.S. tax on a dividend (as determined under section 301(c)(1)) from the subsidiary under either section 881 (for example, by reason of an applicable treaty) or section 882 (thus, there would be no gross basis or other tax on the outbound distribution); or
>
> (iii) in an exchange under section 354 or 356, one or more U.S. persons exchange stock or securities of the target, and the amount of gain in the target stock or securities recognized by those U.S. persons under section 367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that would be treated by the parent as a dividend under section 301(c)(1) and the amount of the deemed distribution that would be treated by P as gain from the sale or exchange of property under section 301(c)(3) if this section would otherwise apply to the triangular reorganization. See reg. section 1.367(a)-3(a)(2)(iv) (providing a similar rule that excludes some transactions from the application of section 367(a)(1)).

The exceptions in situations (i) and (ii) are not implicated in the Endo transaction. However, the

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exception in situation (iii) — referred to as the section 367(b) priority rule (aka the Frazier left hook) — is an issue and is modified by Notice 2014-32 in an important way.

3. The situation (iii) exception and the Frazier left hook.

a. Introduction to the Frazier left hook. Situation (iii) applies when there is an outbound triangular reorganization in which the shareholders of a U.S. target exchange their stock for stock of a foreign acquirer and, but for the gain recognition rule of section 367(a), the shareholders would receive tax-free treatment under section 354 or partial tax-free treatment under section 356. In that situation, the Killer B section 367(b) regulations do not apply, but the section 367(a) gain recognition regulations apply under the following condition:

1. the recognized gain under the section 367(a) gain recognition rule (the aggregate section 367(a) taxable gain) *is equal to or greater than*

2. the sum of

   a. the amount of the deemed distribution that would be treated by P as a dividend under section 301(c)(1) (that is, a taxable dividend out of E&P, hereinafter the taxable dividend amount); and

   b. the amount of the deemed distribution that would be treated by P as gain from the sale or exchange of property under section 301(c)(3) (that is, distributions in excess of E&P and basis) if this section would otherwise apply to the triangular reorganization (hereinafter the capital gain amount).

The taxable dividend amount specified in clause 2.a and the capital gain amount specified in clause 2.b are referred to in Notice 2014-32 as section 367(b) income.

To summarize, the exception in situation (iii) says that in an outbound triangular reorganization, the section 367(b) regulations do not apply but the section 367(a) regulations apply if (1) the aggregate section 367(a) taxable gain *equals or exceeds* (2) the section 367(b) income. Notice 2014-32 refers to this as the ''section 367(a) priority rule.'' A correlative rule in reg. section 1.367(a)-3(a)(2)(iv) says that the section 367(b) regulations apply and the section 367(a) regulations do not apply if the aggregate section 367(a) taxable gain *is less than* the section 367(b) income. Notice 2014-32 refers to this as the section 367(b) priority rule. Both rules say the same thing in substance. This report refers to them hereinafter as the section 367(b) priority rule because, as a practical matter, inverters will want section 367(b) to take priority.

I refer to the section 367(b) priority rule in situation (iii) as the Frazier left hook because it has unexpectedly allowed companies that are engaging in inversions to avoid having their shareholders taxed under section 367(a). The avoidance of section 367(a) makes it more likely that the target's shareholders will vote in favor of the inversion.

b. Endo's use of the Frazier left hook. As indicated previously, in the Endo transaction, the subsidiary, Endo U.S. Inc., is domestic, and the parent, New Endo, is foreign. Consequently, the no-withholding and stripping Killer B regulations apply with a view to (1) preventing the avoidance of gross basis tax, and (2) not facilitating interest stripping. Because the Endo shareholders end up with 77 percent of the stock of New Endo, the transaction is also governed by the section 367(a)(1) gain recognition regulations. Thus, under the section 367(b) priority rule, the section 367 regulation that produces the largest income amount applies.

The Endo proxy/prospectus indicates that the transaction will be managed in such a way that the Killer B regulations, and not the section 367(a) gain recognition regulations, will apply. It contains a detailed discussion of the exception to section 367(a) for specified outbound stock transfers governed by reg. section 1.367(b)-10 — that is, the section 367(b) priority rule. It explains that if specified conditions are satisfied, section 367(a) generally will not apply to a reorganization in which a U.S. subsidiary of a foreign corporation purchases stock of the foreign corporation in exchange for cash, debt, or other non-stock property and uses the purchased stock to acquire another corporation from that corporation's shareholders.

Under the arrangement, Endo U.S. Inc., a subsidiary of New Endo, will be treated as acquiring New Endo ordinary shares from New Endo, a foreign corporation, in exchange for a promissory note. Those New Endo ordinary shares will be used by Endo U.S. Inc. in the Endo share exchange to acquire Endo in the merger. If the specified conditions are satisfied, section 367(a) should not apply and the Endo shareholders should recognize no gain or loss on the Endo share exchange.[11]

The proxy/prospectus elaborates on the deemed distribution and conditions in situation (iii) that must be satisfied for the section 367(b) regulations to take priority. It explains that under the regulations, Endo U.S. Inc.'s acquisition of the New Endo ordinary shares in exchange for the promissory note is treated as a deemed distribution by Endo U.S. Inc. to New Endo in an amount equal to the fair

[11]*See* Section III.C.2.e of Appendix 22C of Thompson, *supra* note 2.

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market value of the promissory note, and the deemed distribution is subject to section 301.[12]

The proxy/prospectus says that the specified conditions in situation (iii) are satisfied if, as a factual and legal matter:

1. a portion of the deemed distribution to New Endo is treated as a dividend under section 301(c)(1);

2. New Endo is subject to U.S. withholding tax on that amount in accordance with the Ireland-U.S. tax treaty; and

3. the sum of (a) the portion of the deemed distribution to New Endo treated as a dividend and (b) the portion of the deemed distribution treated as gain under section 301(c)(3) (that sum is the New Endo income amount or section 367(b) income) exceeds the aggregate built-in gain in the Endo common stock transferred to Endo U.S. Inc. by all U.S. shareholders in the Endo share exchange (that built-in gain is the U.S. shareholders gain amount or aggregate section 367(a) taxable gain).[13]

Whether Endo U.S. Inc. will have positive E&P for the tax year that includes the merger will depend on overall business conditions and its overall tax position for that year, according to the proxy/prospectus.[14] The deemed dividend from Endo U.S. Inc. to New Endo under reg. section 1.367(b)-10 will be treated as a taxable dividend to the extent of Endo U.S. Inc.'s positive E&P for the year of the deemed distribution, and that dividend will be subject to U.S. withholding tax (at a rate of 5 percent) in accordance with the Ireland-U.S. tax treaty.

The proxy/prospectus acknowledges the difficulty of determining the aggregate section 367(a) taxable gain:

> It is uncertain whether the New Endo income amount (aka section 367(b) income) will exceed the U.S. shareholders gain amount (aka aggregate section 367(a) taxable gain), because the U.S. shareholders gain amount cannot be known with certainty until after the closing date. The U.S. shareholders gain amount will depend on the trading price of the Endo common stock and the tax basis of such stock at the time of the Endo share exchange, neither of which can be predicted with certainty. In particular, increases in the Endo stock price following signing of the arrangement agreement and prior to the Endo share exchange may increase the U.S. shareholders gain amount and make it more likely that Endo shareholders will be required to recognize gain (but not loss) on the Endo share exchange. Moreover, because Endo is a public company, information as to the tax basis of the Endo common stock may not be determinable with certainty or obtainable from all U.S. shareholders and is subject to change based on trading activity in the shares. Following closing, New Endo will undertake a study to estimate the tax basis of the shares of Endo common stock at the time of the Endo share exchange in order to assist New Endo in evaluating whether Endo shareholders will be required to recognize gain (but not loss) on the Endo share exchange. Further, the sampling methodology used to determine the U.S. shareholders gain amount or the amount of gain so determined may be challenged by the IRS, and if the IRS were to make such a challenge, there is no assurance that a court would not agree with the IRS.[15]

c. Endo's Frazier left hook. It would appear that to the extent possible, Endo will manage its post-acquisition operations in a way that causes the New Endo income amount to exceed the U.S. shareholders' gain amount so that the section 367(a)(1) gain recognition rule doesn't apply to the Endo shareholders. They will therefore receive tax-free treatment in the transaction. In using reg. section 1.367(b)-10 in this manner, Endo is delivering Treasury a Frazier left hook.

The left hook not only makes the section 367(a) gain recognition rule inapplicable but also facilitates a large interest-stripping game that Endo is playing by having the note issued by Endo U.S. Inc. to New Endo.

4. Notice 2014-32 weakens the Frazier left hook.

a. The glaring defect in the section 367(b) priority rule. Before the issuance of Notice 2014-32, corporations engaged in inversions were paying a small price for the benefit of having the section 367(b) regulations take priority.

First, although the taxable dividend amount of the section 367(b) income paid by the domestic subsidiary to the foreign parent is subject to the 30 percent withholding tax under section 881, the withholding is subject to reduction by an applicable

[12]The deemed dividend is treated as a dividend to the extent of the shareholder's share of the E&P, then as a return of capital to the extent of the shareholder's basis in the stock, then as capital gain to the extent the distribution exceeds the shareholder's basis in the stock.

[13]Section III.C.2.e of Appendix 22C of Thompson, *supra* note 2.

[14]*Id*.

[15]*Id*.

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tax treaty. For Endo, the deemed section 367(b) dividend was only subject to a 5 percent withholding tax under the Ireland-U.S. tax treaty. Thus, the actual tax on the deemed dividend could be very low before Notice 2014-32.

Second, the capital gain amount of the section 367(b) income may or may not be subject to U.S. tax. Capital gain of a foreign corporation that is not realized from a U.S. real property interest is subject to U.S. tax under section 882 only if that gain is effectively connected with the foreign corporation's conduct of a trade or business in the United States. It would appear that in the prototypical inversion, like the Endo inversion, the stock of the inverted corporation is not a U.S. real property interest, and the foreign parent is not engaged in a U.S. trade or business. Therefore, there is no tax on capital gains.

Because of these two factors, an inverter would have to pay a de minimis price in the form of a small withholding tax for the benefit of having the section 367(b) regulations take priority over the shareholder-level tax in section 367(a). Notice 2014-32 notes that the IRS and Treasury are aware that the priority rules may facilitate transactions designed to avoid recognizing gain under reg. section 1.367(a)-3(c).

b. Notice 2014-32 addresses the glaring defect. Notice 2014-32 addresses the situation (iii) exception by announcing that future regulations will modify the amount of income or gain that is considered section 367(b) income for purposes of the priority rule under reg. section 1.367(b)-10:

> Regulations will provide that section 367(b) income includes a section 301(c)(1) dividend or section 301(c)(3) gain that would arise if section 1.367(b)-10 applied to the triangular reorganization only to the extent such dividend income or gain would be subject to U.S. tax or would give rise to an income inclusion under section 951(a)(1)(A) that would be subject to U.S. tax. A conforming change will be made to the section 367(b) priority rule under section 1.367(a)-3(a)(2)(iv).

Thus, by providing that section 367(b) income includes only the dividend income or gain, or the section 951 inclusion that would be subject to U.S. tax (the U.S. tax requirement), Notice 2014-32 increases the price inverters must pay to have the section 367(b) regulations take priority over the section 367(a) regulations. However, the notice does not eliminate the section 367(b) priority rule. In other words, the notice has weakened but not blocked the Frazier left hook.

Also, even with the U.S. tax requirement, an inverter likely could ensure there was sufficient E&P so that the section 367(b) income would exceed the aggregate section 367(a) taxable gain and the section 367(b) rules would therefore take priority. And if the foreign parent is organized in a country like Ireland, which has a 5 percent withholding rate on dividends, the tax cost of securing section 367(b) priority treatment would not be that great, particularly when compared with the 23.8 percent combined capital gains and net investment income tax rate that is likely to apply to the section 367(a) capital gains of the target's shareholders. The bottom line is that while Notice 2014-32 increases the cost of prioritizing the section 367(b) regulations, it will not be a significant deterrent to inverters.

c. Notice 2014-32's modifications to the antiabuse rule. The antiabuse rule of reg. section 1.367(b)-10(d) provides that appropriate adjustments will be made ''if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of this section.'' Notice 2014-32 extends that rule:

> The anti-abuse rule in section 1.367(b)-10(d) will be clarified to provide that S's acquisition of P stock or securities in exchange for a note may invoke the anti-abuse rule. In addition, section 1.367(b)-10(d) will be clarified to provide that the earnings and profits of a corporation (or a successor corporation) may be taken into account for purposes of determining the consequences of the adjustments provided in the final regulations, as modified by the rules announced in this notice, regardless of whether such corporation is related to P or S before the triangular reorganization. Thus, the earnings and profits of T (or a successor to T) or a subsidiary of S or T may be taken into account for purposes of determining the consequences of the adjustments provided in the final regulations, as modified by the rules announced in this notice.

That interpretation of the antiavoidance provision could work to the advantage of inverters because it would make it more likely that an inverter could generate enough E&P so that the section 367(b) income would exceed the aggregate section 367(a) taxable gain, thereby giving priority to the section 367(b) Killer B regulations.

VI. Treasury's Counter

In Ali's rematch with Frazier, the ''Thrilla in Manila,'' Ali avoided Frazier's left hook and won the fight. Although Notice 2014-32 weakens the Frazier left hook, Treasury must disable it altogether to win the section 367 fight.

First, there is little question that in issuing the Killer B regulations, Treasury neither intended nor anticipated the type of gamesmanship used by Endo and other inverters — games that are still played today. For example, it seems clear from

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Notice 2006-85 that the ''avoidance of gross basis tax'' provision of the Killer B rules was directed at the tax-free distribution of earnings from a U.S. subsidiary to a long-term foreign parent, not the type of transaction in which the foreign parent is newly formed, like New Endo. Unlike New Endo, a long-term foreign parent may have made a real loan of funds to the U.S. subsidiary and therefore be entitled to repayment and interest. By contrast, the promissory note from Endo U.S. Inc. to New Endo is not issued for funds that Endo U.S. Inc. has received.

Second, in this circumstance, the note-for-stock transaction is artificial on its face, lacks a true business purpose, and arguably should be treated as a constructive dividend regardless of the Killer B regulations. Moreover, the note-for-stock transaction is not essential for qualifying the transaction as a triangular reorganization because (1) the parent could transfer its stock directly to the target's shareholders, or (2) the parent could contribute the stock to the subsidiary, which could then transfer the stock to the target's shareholders. In both cases, the transaction would qualify as a reorganization.

Third, although the scope of the antiabuse rule in reg. section 1.367(b)-10(d) is not completely clear, Treasury might use that rule to make both the section 367(a) gain recognition rule and the deemed dividend rule (or a similar constructive dividend rule) apply in inversions. Indeed, it is curious that Treasury treats the note-for-stock part of an inversion transaction as a non-outbound transaction under the section 367(b) regulations. The note-for-stock part of the transaction is clearly part of a larger outbound transaction (that is, the exchange by the U.S. shareholders of their stock in the U.S. target for stock in the foreign holding company). And because the larger outbound transaction is governed by the section 367(a) regulations, the note-for-stock part of the transaction should also be subject to section 367(a). This type of change could be accomplished by providing under the section 367(a) regulations that the note-for-stock part of an inversion transaction is a deemed distribution.

Fourth, possibly the most direct approach would be for the IRS and Treasury to issue a notice saying that the section 367 regulations would be changed, effective on the date of the notice, to expressly bring these transactions back under section 367(a) as well as under section 367(b). Apparently, Killer B transactions were stopped immediately after the issuance of the original Killer B notice, Notice 2006-85.

Finally, it would appear that these types of approaches would be consistent with the codification of the economic substance doctrine in section 7701(o).

So the answer is that Treasury, like Ali, can overcome the weakened-but-still-viable Frazier left hook. And it should quickly address the issue in order to take pressure off tax professionals who are reluctant to engage in inversion transactions but are pushed by the competition for clients to do so.

VII. Must Congress Enter the Fight?

A. The Inversion Trend Will Continue

The inversion trend will continue despite Treasury's efforts. For example, three days after the issuance of Notice 2014-32, Pfizer, a large publicly held U.S. corporation, announced its proposed acquisition of AstraZeneca PLC, a large publicly held U.K. company, in a $99 billion inversion transaction[16] — the largest ever, had AstraZeneca not rejected Pfizer's ''final'' offer.[17] Both companies would have become subsidiaries of a U.K. holding company. The day following Pfizer's announcement, a leading mergers and acquisitions law firm issued a client memorandum saying that the inversion trend can be expected to continue, given the pressure to ''act before possible future regulatory action lessens the benefit of such deals.''[18]

To stop this trend, Congress should reenter the fight, as it did in 2004 with the enactment of section 7874. Lawmakers should pursue the policies discussed below and, from a longer-term perspective, consider fundamental reform of the international tax system.

B. How Congress Should Fight Directly

One strategy for Congress to throw more forceful and direct punches at inversions would be to:

1. lower from 80 percent to 60 percent the threshold in section 7874 for treating a foreign holding company as a U.S. company; and

2. provide that for any inversion in which the shareholders of a U.S. corporation end up with from 50 percent to 60 percent of the stock of the foreign holding company, the following rules will apply: (a) the section 367(a)(1) gain recognition rule; (b) the inversion gain rule in section 7874; (c) a new rule which, at the time of the inversion, would treat the U.S. corporation as if it had disposed of each of its CFCs in a taxable transaction, thereby ending the deferral benefit; and (d) a strengthened section

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[16]Pfizer Inc., SEC Form 8-K, Apr. 28, 2014. *See also* Victor Fleischer, ''How Tax Laws Distort the Pfizer Deal,'' *The New York Times*, Apr. 29, 2014.

[17]Jenny Anderson, ''Pfizer Abandons Bid for AstraZeneca,'' *The New York Times*, May 26, 2014.

[18]Wachtell, Lipton, Rosen & Katz, ''An Upturn in Inversion Transactions'' (Apr. 29, 2014).

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163(j) interest-stripping rule that would operate in a manner similar to proposed new section 267A.[19]

As an alternative, Congress could pass the anti-inversion legislation recently and separately proposed by (1) the Obama administration;[20] (2) Sen. Carl Levin, D-Mich.;[21] and (3) House Ways and Means Committee ranking minority member Sander M. Levin, D-Mich.[22] As indicated in Sen. Levin's press release announcing his bill, all of these approaches are similar.[23] Basically these proposals would (1) reduce the 80 percent threshold in section 7874 to 50 percent and eliminate the 60 percent test, and (2) without regard to the level of shareholder continuity, prevent a U.S. company from shifting its tax residence to a foreign jurisdiction if the corporation is managed and controlled in the United States and has significant business operations there.

Also, in an op-ed in *The Wall Street Journal*, Senate Finance Committee Chair Ron Wyden, D-Ore., said that any anti-inversion legislation ultimately adopted will apply to deals done after May 8, 2014.[24]

It does not appear, however, that anti-inversion legislation will be adopted anytime soon. For example, *Tax Notes* recently reported that ''several Democratic taxwriters, including [Senator Wyden], joined congressional Republicans in saying the [inversion] issue should be addressed as part of tax reform,''[25] which is the next topic addressed here.

C. Fundamental International Tax Reform

The Senate Finance Committee and the House Ways and Means Committee have both proposed international tax reform.[26] The Senate is considering a minimum tax on deferred income with tax-free repatriation. The House is considering a territorial regime that would exempt foreign business income from U.S. tax except for a tax on 5 percent of dividends received by a U.S. parent from a foreign subsidiary.

Neither proposal would eliminate the benefit of foreign investment over domestic investment. (In fact, the House proposal would likely increase it.) Therefore, the inversion problem would persist, and there would continue to be a need for direct anti-inversion and anti-base-erosion provisions. Also, neither proposal would completely eliminate the lockout effect, which tends to deter the repatriation of foreign earnings.

There is no silver bullet for the inversion problem. However, there would likely be less incentive for inversions if Congress adopted an imputation system and used the tax revenues from that system to significantly lower the corporate tax rate for all corporations.[27] An imputation system would also eliminate the lockout effect and largely reduce base erosion opportunities. To be clear, an imputation system would not entirely remove the incentive to invert, so there would be a continued need for anti-inversion provisions.

The lower corporate rate resulting from an imputation system would answer the lament about the proposed Pfizer inversion expressed by Ways and Means Committee Chair Dave Camp, R-Mich.:

> Clearly one of the reasons I saw regarding the Pfizer situation was tax rates. And one of the things that tax reform is going to try and do is lower rates. The business community has come and said, ''We can't remain competitive with the highest corporate rate in the world.'' And so I think that again makes the case. How many more companies have to be headquartered [or] based in lower-tax jurisdictions before we get the message?[28]

D. Tea Party, Others Should Support the Fight

The Tea Party is a political movement that, *inter alia*, advocates for a reduction in taxes. It is commonly thought that because of its anti-tax position the Tea Party will object to the anti-inversion legislation proposed by three Democrats: President Obama, Sen. Levin, and Rep. Levin.

For at least three reasons, the Tea Party should be the strongest supporter of what should be a bipartisan congressional fight against inversions. First, whereas the Boston Tea Party was a protest against

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[19]Proposed new section 267A would disallow deductions for related-party payments arising in a base erosion arrangement. *See* Joint Committee on Taxation, ''Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation,'' JCX-15-13, at 80 (Nov. 19, 2013).

[20]Treasury, ''General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,'' at 65 (Mar. 4, 2014).

[21]S. 2360, Stop Corporate Inversion Act of 2014.

[22]H.R. 4679, Stop Corporate Inversions Act of 2014.

[23]Senator Carl Levin, Press Release on Stop Corporate Inversion Act of 2014 (May 20, 2014).

[24]Martin A. Sullivan, ''Lessons From the Last War on Inversions,'' *Tax Notes*, May 26, 2014, p. 861. This article presents a comprehensive discussion of the history of Congress's consideration of the inversion issue. This history and other aspects of inversions are also explored in the CRS report, ''Corporate Expatriation, Inversions, and Mergers: Tax Issues'' (May 28, 2014).

[25]Lindsey McPherson and Andrew Velarde, ''Democrats Disagree on Legislative Fix for Inversions,'' *Tax Notes*, May 26, 2014, p. 876.

[26]*See* Thompson, ''Logic Says No to Options Y, Z, and C, but Yes to Imputation,'' *Tax Notes*, May 5, 2014, p. 579.

[27]*Id.*

[28]Andrew Velarde, ''High Tax Rates Responsible for Pfizer Inversion, Camp Argues,'' *Tax Notes*, May 5, 2014, p. 537. *See also* Sullivan, *supra* note 24.

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the imposition of British taxes on Americans, inversions have the effect of subjecting American companies to foreign taxes, which in the case of the Pfizer, would be British taxes. Philosophically, one would expect that the Tea Party would be against the out-sourcing of the taxation of American companies to foreign countries.

Second, as pointed out in my *Logic* article, inversions are in large part about promoting foreign investment over American investment. One would expect the Tea Party to be strong supporters of investment in America and, therefore, strongly against inversions.

Third, as pointed out above, the coupling of anti-inversion legislation with an imputation system could, on a tax neutral basis, significantly reduce taxes on all corporations doing business in America, thus addressing a fundamental tenet of the Tea Party.

VIII. Two Collateral Issues

A. A Word on Avoidance of Section 956

Sections 951(a)(1)(B) and 956 apply to certain indirect repatriations of deferred foreign income. For example, if a CFC made a 10-year loan to its U.S. parent, the loan would be treated as a dividend distribution from the CFC to the U.S. parent, thereby eliminating the deferral benefit.

Some taxpayers may attempt to use inversions as a way around sections 951(a)(1)(B) and 956. For example, after an inversion, a long-time CFC of the U.S. parent could make a 10-year loan to the new foreign holding company, which in turn could make a similar loan to the U.S. parent, which is a sub of the foreign holding company. By using these back-to-back loans, the parties could argue that the indirect repatriation rules are not applicable. Treasury should make it clear that this and similar transactions do not avoid those rules.

B. Gross-Ups for Payment of the Excise Tax

Section 4985 imposes a 15 percent excise tax on certain ''specified [unrealized] stock compensation-held (directly or indirectly) by or for the benefit of'' certain high-level executives of an inverted corporation. In many cases the inverted company will bear the burden for those taxes through gross-up provisions. This was apparently the case in the Endo transaction.[29]

In connection with its examination of inversion transactions, Congress should consider both (1) raising the rate of this excise tax, and (2) restructuring the tax to make it a greater barrier to inversions.

IX. Conclusion

In my view, Treasury and Congress need to be more aggressive in fighting inversions. Treasury should take action to completely eliminate the Frazier left hook, which inverters will still throw even in its weakened form. Given the timing of Pfizer's announcement and a leading M&A firm's prediction that inversions will continue, Notice 2014-32 is likely not seen as an effective deterrent to inversions.

Congress should make it tougher to invert and impose a higher price on corporations that successfully invert. Also, while not a panacea for inversions, the incentive to invert would likely decrease if Congress adopted an imputation system and used the enhanced revenues to lower the corporate tax rate for all corporations.

These more forceful punches against inversions would make for good tax policy by further deterring a corporation from taking advantage of the business opportunities the United States offers and then using an inversion to undermine the U.S. tax system. It would also reduce the amount of time tax lawyers spend on artificial transactions that are merely designed to beat Treasury out of a dollar.

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[29]Zachary R. Mider, ''Endo to Pay Executives' $60M Tax Bill For Relocating Company to Irish Address,'' *DTR* (May 16, 2014).

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