SLIDES ILLUSTRATING (1) A PROTOTYPICAL INVERSION TRANSACTION, AND (2) THE IMPACT OF TREASURY’S 2016 INVERSION AND SECTION 385 REGULATIONS
Accompanying Thompson, A Basic Guide to the Treasury’s April 2016 Regulations in Inversions and Inter-Company Debt
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**Prototypical Inversion Transaction**

**Slide #1 Pre-Inversion Structure**

- **Entity Key**
  - Corporations = presence of a new foreign holding company
  - Shareholders = structure involving public shareholders

- **Public Shareholders**

- **U.S. Acquirer Aka: “Domestic Inverter”** (its shareholders end up with more than 50% of the stock of New Foreign Holding Company)

- **U.S. Merger Sub**

- **Foreign Amalgamation Sub**

- **Public Shareholders**

- **Foreign Inversion Target** (its shareholders end up with less than 50% of the stock of New Foreign Holding Company)

↑ $956: Indirect repatriations from CFCs results in income inclusion for U.S. Acquirer of Trapped Foreign Earnings.

- **Controlled Foreign Corporation #1 = CFC1 Aka:** “DI’s CFC #1” (Deferred “Trapped” Foreign Earnings)*

- **Controlled Foreign Corporation #2 = CFC2 Aka:** “DI’s CFC #2” (Deferred “Trapped” Foreign Earnings)*

*Total Deferred “Trapped” Foreign Earnings of all CFCs = $2 trillion ($1 trillion in cash)
PROTOTYPICAL INVERSION TRANSACTION

SLIDE #2 SUMMARY OF THE PRE-INVERSION STRUCTURE

New Foreign Holding Company

Public Shareholders

Public Shareholders

Domestic Inverter

U.S. Merger Sub

Foreign Amalgamation Sub

Foreign Inversion Target

§956: Indirect Repatriations from CFCs results in income inclusion for U.S. Acquirer of Trapped Foreign Earnings.

DI’s CFC #1

DI’s CFC #2
PROTOTYPICAL INVERSION TRANSACTION

SLIDE #3 THE INVERSION TRANSACTION

[2b] Debt Instrument of Domestic Inverter issued for Stock of New Foreign Holding Co to set up Interest Stripping

New Foreign Holding Company

[2b]

Public Shareholder

[2c] Stock of New Foreign Holding Co issued to Pub Shareholders

Domestics Inverter

[2a] RSM

U.S. Merger Sub

Foreign Amalgamation Sub

Foreign Inversion Target

[1b] Stock of Foreign Holding Co.

[1a]

Public Shareholder

Step 2. Merger Sub merges into Domestic Inverter in a Reverse Subsidiary Merger (RSM). Consideration: Stock of New Foreign Holding Co amounting to more than 50% but less than 80% of the Stock of Foreign Holding Co. Note: If 80% or more, then under § 7874, New Foreign Holding Company is treated as a U.S. corporation.

Step 1. Amalgamation Sub and Foreign Inversion Target consolidate pursuant to a Plan of Arrangement or Scheme of Arrangement. Consideration:

*Stock of Foreign Holding Company amounting to more than 20% but less than 50% of the Stock of Foreign Holding Co.

*Possibly some cash to satisfy the more than 20% but less than 50% requirement.
Reg. §1.7874-4T disregards stock of FHC issued for PRS business assets in a transaction related to the DI acquisition with the "principal purpose of avoiding the purposes of section 7874." PRS's shares in FHC are disregarded. FHC is domestic.
$1.7874-7T$ will disregard certain stock of Foreign Inversion Target (FIT) attributable to passive assets, effectively ensuring that FIT's net active assets must have a value of at least 21% of the stock of FHC. A similar rule applies for the §367 substantiality test.
§ 1.7874-9T disregards stock of the New Foreign Holding Company that is issued to the shareholders of the Foreign Inversion Target for the purpose of determining whether the 80% threshold is met.

[Ownership Percentage Calculation: 65 / (100-35) = 100%]

The Old Shareholders of Domestic Inverter

[65 FHC shares]

[35 FHC shares to be disregarded]

New Foreign Holding Company (FHC) = a Domestic Corp (A tax resident of Country Y)

In the transaction, FHC acquired all the stock of DI with 65 shares of the newly issued FHC stock.

Domestic Inverter (DI)

Foreign Inversion Target (FIT) (A tax resident of Country X)*

In the transaction, FHC acquired all the stock of FIT with the remaining 35 shares of the newly issued FHC stock.

* Note: FIT is a resident of a Cty X, and FHC is a resident of Cty Y, a third country. See the Example in § 1.7874-9T(f).
Section 1.7874-10T will disregard certain "slimming down" distributions by Domestic Inverter that are designed to ensure that the fair market value of its stock is such that its shareholders receive no more than 79% of the stock of FHC.

Diagram:
- **Public Shareholders**
  - Domestic Inverter
    - DI's CFC #1
    - DI's CFC #2
  - U.S. Merger Sub
  - Foreign Amalgamation Sub
  - New Foreign Holding Company (FHC)
  - Foreign Inversion Target
2016 TREASURY INVERSION REGULATIONS: IMPACT ON INVERSION STRUCTURE

SLIDE #10 SPINVERSION, THE SPIN, REG § 1.7874-6T(g), EXP 1, USP SPINS OFF DT TO FA

(Flowchart: Individual -> USP (Domestic Corp) -> FA (Foreign Acquiring Corp) -> DT (Domestic Corp) [1a] FA Stock (FA to USP) [lb] DT Stock (USP to FA) [2] Distribute USP Stock (USP to A))

Other Assets
2016 TREASURY INVERSION REGULATIONS: IMPACT ON INVERSION STRUCTURE

SLIDE #11 SPINVERSION, AFTER, REG § 1.7874-6T(g), EXP 1: DT HAS INVERTED AS SUB OF FA

A
Individual

FA
(Foreign Acquiring Corp)

DT
(Domestic Corp)

USP
(Domestic Corp)

Other Assets
2016 TREASURY INVERSION REGULATIONSE: POST-INVERSION TAX AVOIDANCE
SLIDE #12 ANTI-HOPSCOTCH LOAN RULE, REG § 1.956-2T(a)(4)

Old Public Shareholders of Domestic Inverter

Old Public Shareholders of Foreign Inversion Target

51% - 79%

21% - 49%

New Foreign Holding Company (FHC)

Domestic Inverter (DI)

Foreign Inversion Target

DI's CFC #1

DI's CFC #2

§ 1.956-2T treats "Out-From-Under," "Hopscotch" Loans from CFCs to FHC as a dividend (see dotted line) to DI under Section 956.
2016 TREASURY INVERSION REGULATIONSE: POST-INVERSION TAX AVOIDANCE

SLIDE #13 ANTI-DECONTROL OF CFC RULE, REG § 1.7701-1(l)

Old Public Shareholders of Domestic Inverter

51% - 79%

Old Public Shareholders of Foreign Inversion Target

21% - 49%

New Foreign Holding Company (FHC)

[1] Cash or Property

[2] Stock of DI’s CFC #2 that De-Controls it.

Domestic Inverter (DI)

Foreign Inversion Target

DI’s CFC #1

DI’s CFC #2

Under § 1.7701(l)=4T, this de-controlling transaction ([1] and [2]) is recharacterized as a contribution (see dotted lines [3a] and [3b]) from FHC to DI then followed by a matching contribution by DI to DI’s CFC #2. DI’s CFC #2 is the paying agent for DI.
TREASURY INVERSION REGULATION: POST-INVERSION TAX AVOIDANCE
SLIDE #14 CFC STOCK DILUTION RULE, REG. § 1.367(b)-4T(e)

Old Public Shareholders
of Domestic Inverter

51% - 79%

Old Public Shareholders
of Foreign Inversion
Target

21% - 49%

New Foreign Holding Company
(FHC)
Also=FA

Domestic Inverter
(DI)
Also=DT

All CFC#1’s stock: FMV: $150x; Basis $50x
60% of FIT's voting stock

Foreign Inversion Target
Also=FS

DI’s CFC #1
Also=FT

DI’s CFC #2

$60x attributable
earnings & profits

Under § 1.367(b)-4T(e), DI must include the $60x
in income as deemed dividend, i.e., the § 1248 amount.
Also, under § 1.367(b)-4T(e), DI must recognize all
realized gain with respect to CFC#1’s stock after taking into
account any increase in basis resulting from the deemed
dividend. In this example, DI must recognize: $150x – ($50x
– $60x) = $40x. If CFC#1 had no E&P, DI would recognize
$100x of realized gain.
After this transaction, DI's CFC #2 owns stock in its parent DI. Reg. § 1.304-7T provides that under certain circumstances, no portion of the distribution [1b] is a dividend from the E & P of DI's CFC #2. $100K of cash is a dividend from DI to FHC. Thus, the deferred earning of DI's CFC #2 is not reduced.
Old Public Shareholders of Domestic Inverter

51% - 79%

Old Public Shareholders of Foreign Inversion Target

21% - 49%

Debt Instrument of U.S. Acquirer: Interest Stripping

New Foreign Holding Company (FHC)

Domestic Inverter

DI's CFC #1

DI's CFC #2

Foreign Inversion Target

Subject to certain exceptions, § 1.385-3 will treat a note like the one running from Domestic Inverter to FHC as equity, thereby eliminating any interest stripping.