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Cross-Border M&A:

Inversions and Notice 2015–79

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The (Continuing) Administrative Response to Inversions
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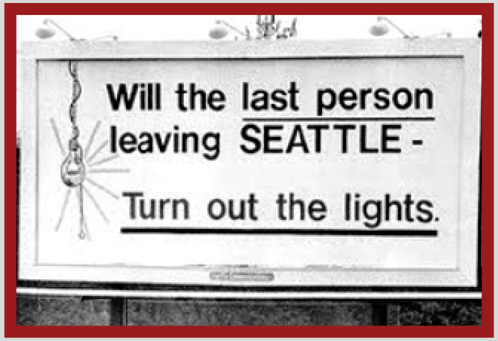
Inversion Background

Last One Out, Please Turn Off the Lights

The new Wall Street rule for Corporate America?

- Several mainline companies have "inverted" or are considering doing so
- In several instances, SH groups have advanced the idea
- Do BODs have affirmative duty to explore?

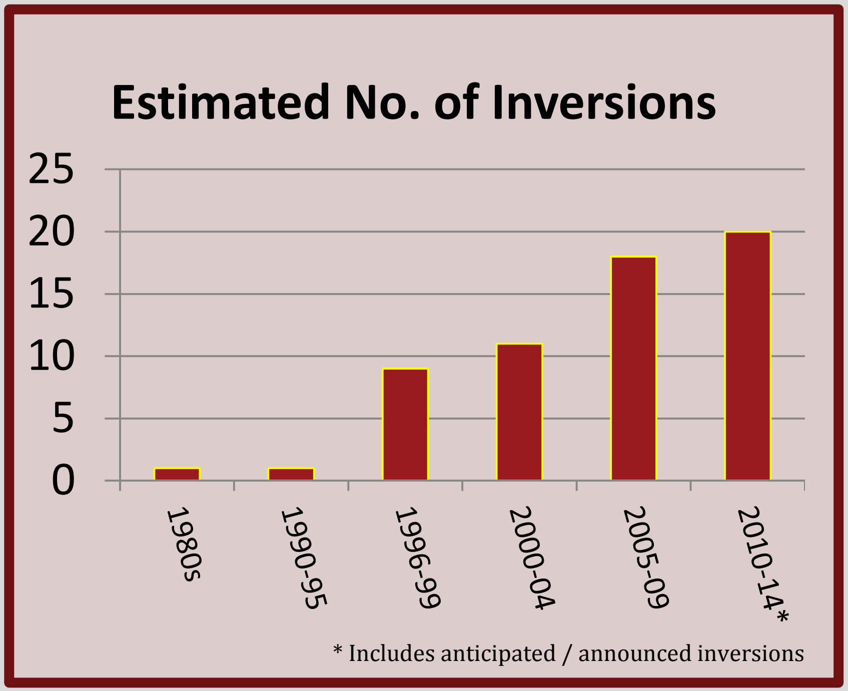


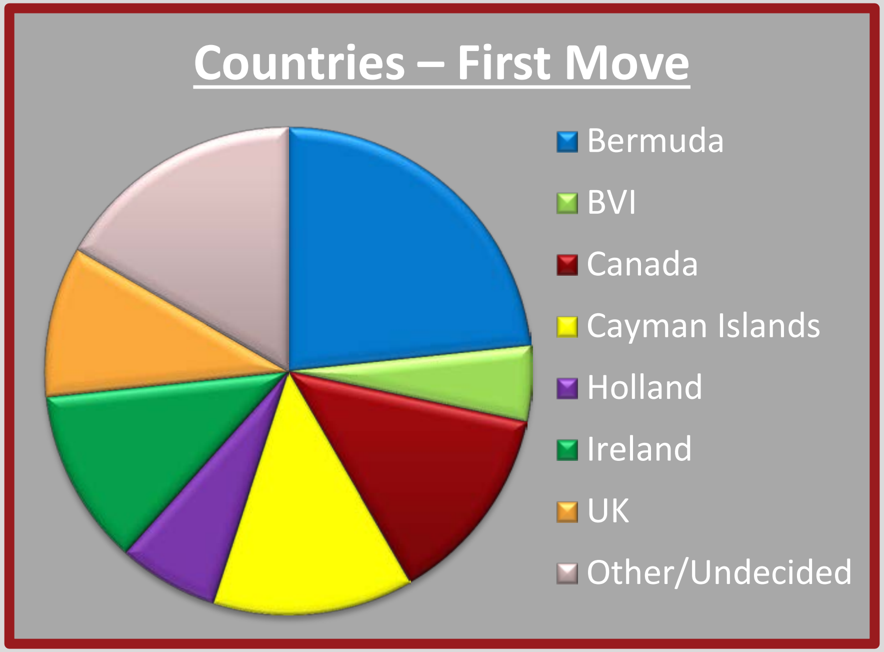
Why do companies "invert" (beyond pure corporate synergies)?

- 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
- Globalization – often growth for a US MNE is *outside* its home market
- Viable "home base" alternatives – educated workforce, vibrant cities, strong legal protections
- Fatigue with political gridlock and the demonization of US-based global enterprises

Inversion Trendlines

More than 50 companies have inverted or have plans to invert





Earlier period: Bermuda, Cayman Islands

More recently: Ireland, UK, Canada, Holland

THE EARLY DAYS

The 1980s

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

The 1990s

- Helen of Troy's move to Bermuda triggered promulgation of current <u>Treas. Reg. § 1.367(a)-3(c)</u>
  - Target's US SHs are generally taxed (despite non-recognition provisions) if (<u>any</u>):

    (1) <u>more than 50%</u> 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 <u>shareholder-level taxation</u>, with possible escape for "true" business deals

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 to mid-2012

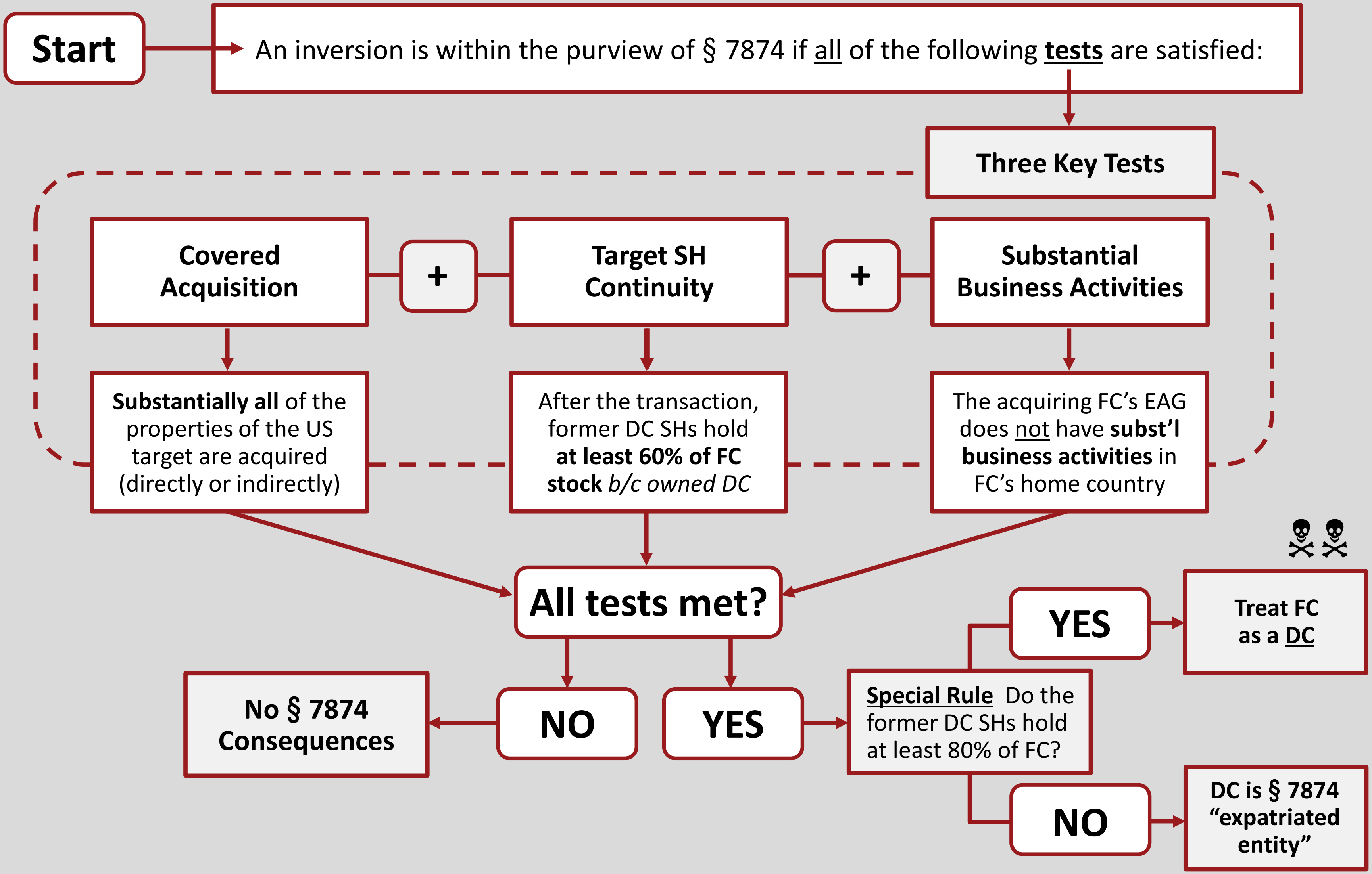
- Congress adopted <u>§ 7874</u> and <u>§ 4985</u> in 2004
  - § 7874 essentially operates either to (1) fully-eliminate the consequences of an inversion, or (2) permit the inversion, but make post-inversion tax planning more difficult to achieve
    - Focuses on <u>corporate-level taxation</u>, with 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 <u>taxing executives</u> and other persons responsible for the inversion
- Other post-2004 gov't attempts to slow inversions (*e.g.*, § 457A, reg. changes, Notice 2014-32)

Modern Transactions

2012 onward: era of 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
  - **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
- **Administrative approach** – in absence of legislative solutions, the Administration has taken steps to curb perceived abuses in the cross-border M&A space by promising to issue a series of complex (and creative) technical rules
  - **Notice 2014-52**
  - **Notice 2015-79**
- **Is this a satisfactory "solution"?** – history shows that highly-technical rules often lead to unforeseen consequences

§ 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 <u>more than 50% vote and value</u>
- **Current 25% test** – EAG has SBA in FC's "home" country only if <u>all</u> the following are met:
  - **<u>Group employees</u>** – 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
  - **<u>Group assets</u>** – 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
  - **<u>Group income</u>** – 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 <u>and</u> 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

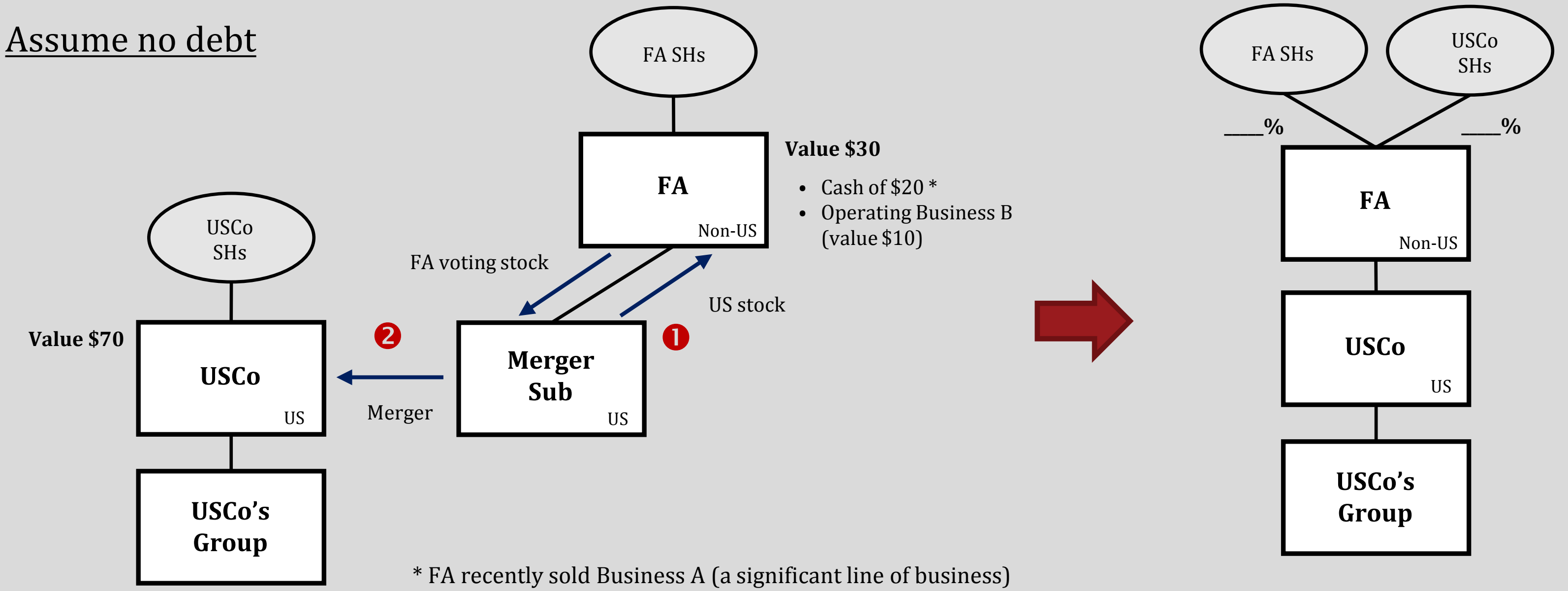
Notice 2014–52

Notice 2014-52: Inversions & Benefits

Notice 2014-52

- Treasury/IRS issued this notice amid intense public-scrutiny of inversions transactions; the provisions of the notice apply <u>solely to "inverters"</u> (except for one § 304 provision applicable to all persons), generally makes it more difficult to achieve post-inversion benefits or pass the § 7874 ownership threshold, and targets transactions occurring <u>on/after September 22, 2014</u>.
- **Framework of Notice**
  - **Overview (Notice § 1)**
  - **Regulations to address inversion transactions (Notice § 2)**
    - Anti-cash box; foreign-acquirer passive-asset "stuffing" (§ 7874) – § 2.01
    - Anti-slimming; US-target "slimming" distributions (§ 367 / § 7874) – § 2.02
    - "Spinversions"; subsequent transfers of stock of FA (§ 7874) – § 2.03
      - US-parented group rule
      - Foreign-parented group rule [a taxpayer-friendly rule]
  - **Regulations to address post-inversion tax avoidance transactions (Notice § 3)**
    - Acquisition of stock / obligations that would otherwise avoid § 956 – § 3.01
    - De-controlling / diluting CFCs (§ 7701(l) / § 367(b)) – § 3.02
    - Rules under § 304 to prevent E&P removal – § 3.03
  - **Effective dates (Notice § 4)**
  - **Request for comments / *in terrorem* clause (Notice § 5)**

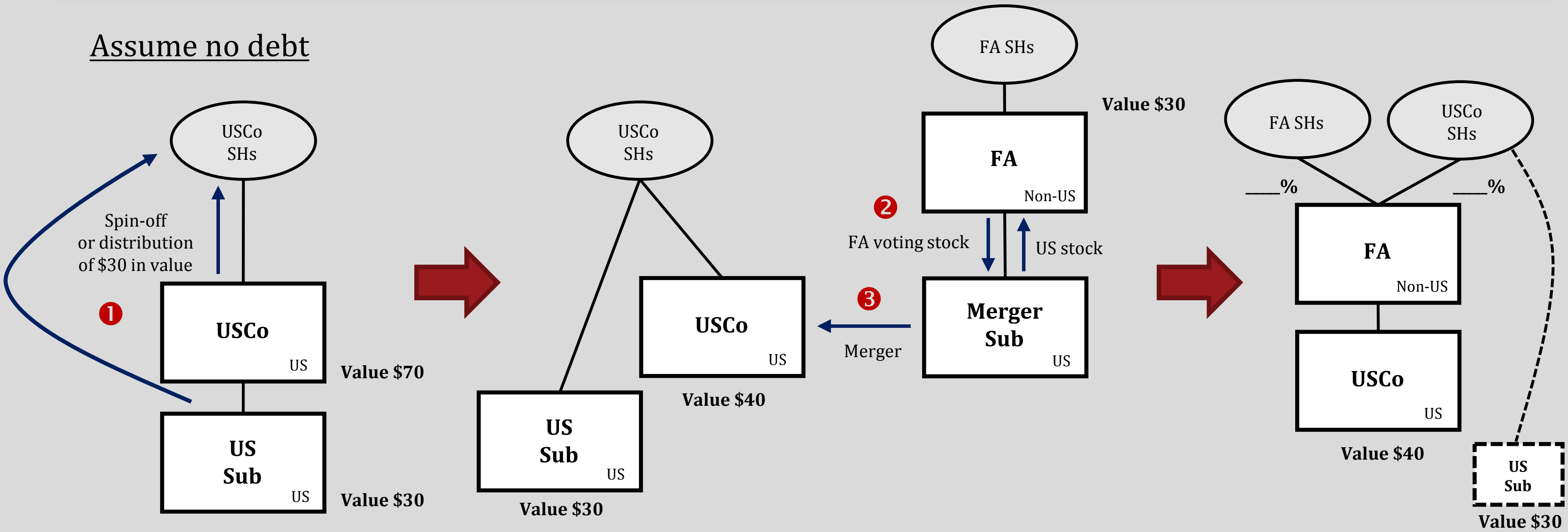
Anti-Cash Box Rules



Notice § 2.01 – Anti-cash box

- *Relevant authorities* – § 7874(c)(4), § 7874(c)(6), § 7874(g)
- *Background* – § 7874(c)(2)(B) (statutory public offering rule) says stock of FA sold in "related" public offering is excluded from denominator, and Treas. Reg. § 1.7874-4T (Jan. 2014) extends this concept to non "public offering" setting, by identifying "disqualified stock" (stock that is excluded from denominator, generally b/c it is transferred in exchange for "nonqualified property" such as cash or cash equivalents); Notice 2014-52 extends this further
- *Notice view* – the -4T reg addressed exchange-acquired nonqualified property, but not nonqualified property held by FA yet not acquired in a transaction related to the "inversion." (Consider, for instance, a public FA that previously sold its business.) Result is FA stock included in denominator yet related to significant passive assets. Thus, T/IRS will issue regs under authority of § 7874(c)(6)
- *Notice rules* – if more than 50% of the gross value of all "foreign group property" is "foreign group non-qualified property" then portion of FA stock is excluded from the SH continuity test denominator, based on a fraction

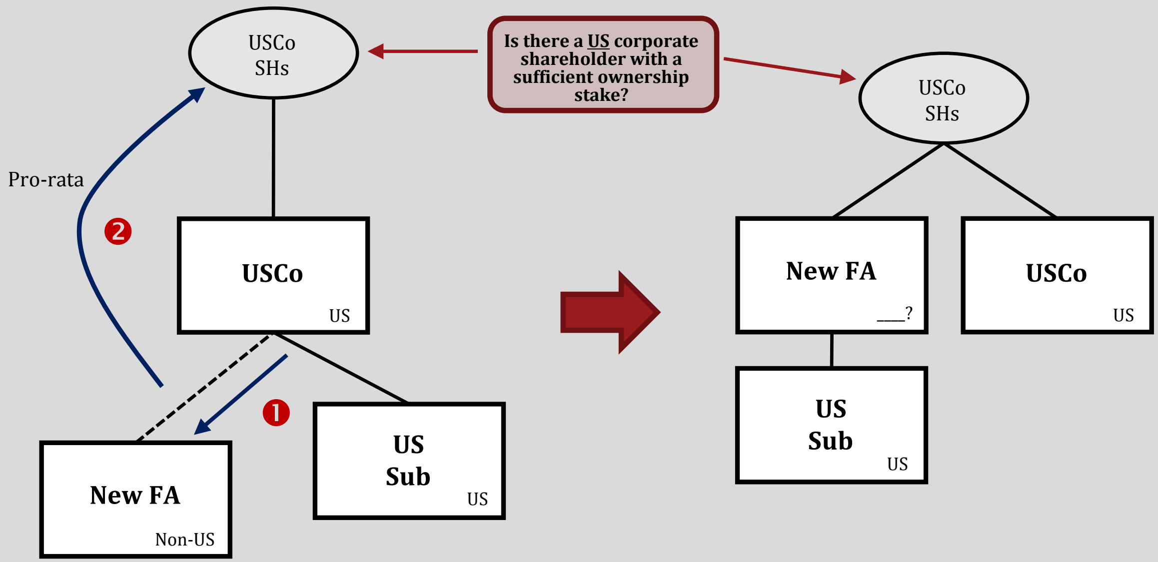
Anti-Slimming Rules



Notice § 2.02 – Anti-slimming

- *Relevant authorities* – Reg. §1.367(a)-3(c), § 7874(c)(4)
- *Background* – Reg. §1.367(a)-3(c) has a "substantiality" requirement associated with the FA active business rule (i.e., there's a value test), and § 7874(c)(4) gives authority to disregard transfers if associated with a plan a principal purpose of which is to avoid purposes of § 7874. T/IRS is aware that some DCs may distribute property to former SHs to (1) reduce numerator in SH continuity test, and (2) help satisfy the substantiality test of the § 367(a) regs
- *Notice rules* – "non-ordinary course distributions" made by US Target (or its predecessors) during 36-month period prior to an "inversion" will be treated as part of a plan a principal purpose of which is to avoid § 7874, and thus will be disregarded for § 7874 purposes. Further the HOT regs will be modified to apply similar principles.
- *Non-ordinary course distribution* – excess of distributions by DC during this tax year *over* 110% of average of all such distributions during the 36 month period prior to this tax year. A "distribution" is *any distribution*, whether or not a "dividend," § 355 qualified or boot to DC SHs in a reorg

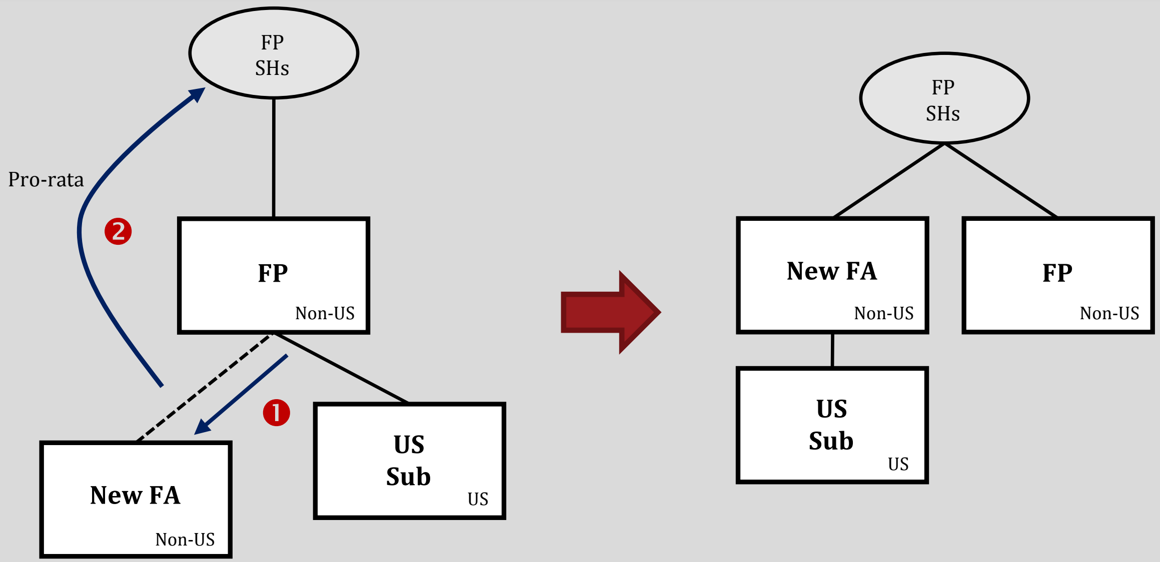
"Spinversion" Rules (US-Parented)



Notice § 2.03 – US-parented group

- *Relevant authority* – § 7874(c)(2)(A) (statutory EAG rule)
- *Background* – § 7874(c)(2)(A) provides that FA stock held by members of the EAG is not included in numerator or denominator, so normally a contribution of all DC shares to a new FC would not trigger § 7874 b/c the ownership fraction is 0/0 after applying statutory EAG rule. It does not always yield the correct results, so the regs contain exceptions to it that exclude stock from numerator but not denominator – see (1) internal group restructuring, and (2) loss of control. See Reg. § 1.7874-1(c)(2)-(3). The –5T regs address the impact on numerator where (1) former DC SHs receive FA stock *(cont'd)*
- *(cont'd)* by reason of holding stock in DC, and (2) thereafter transfer that FA stock; the subsequent disposition of the "by reason of" stock generally does not kick that stock out of the numerator, unless it is excluded from fraction by EAG rules. A preamble warned of potential issues with divisive § 355 txns
- *Notice rule* – FA stock received by former corp SH of DC and subsequently transferred in related transaction will not be considered held by member of EAG for purposes of applying the EAG rules (thus, the FA stock is included in numerator and denominator) UNLESS (1) *before and after* the acquisition, the transferring corp is a member of a US-parented group, and (2) *post-acquisition*, both the person holding the transferred FA stock *and* the FA are members of the US-parented group

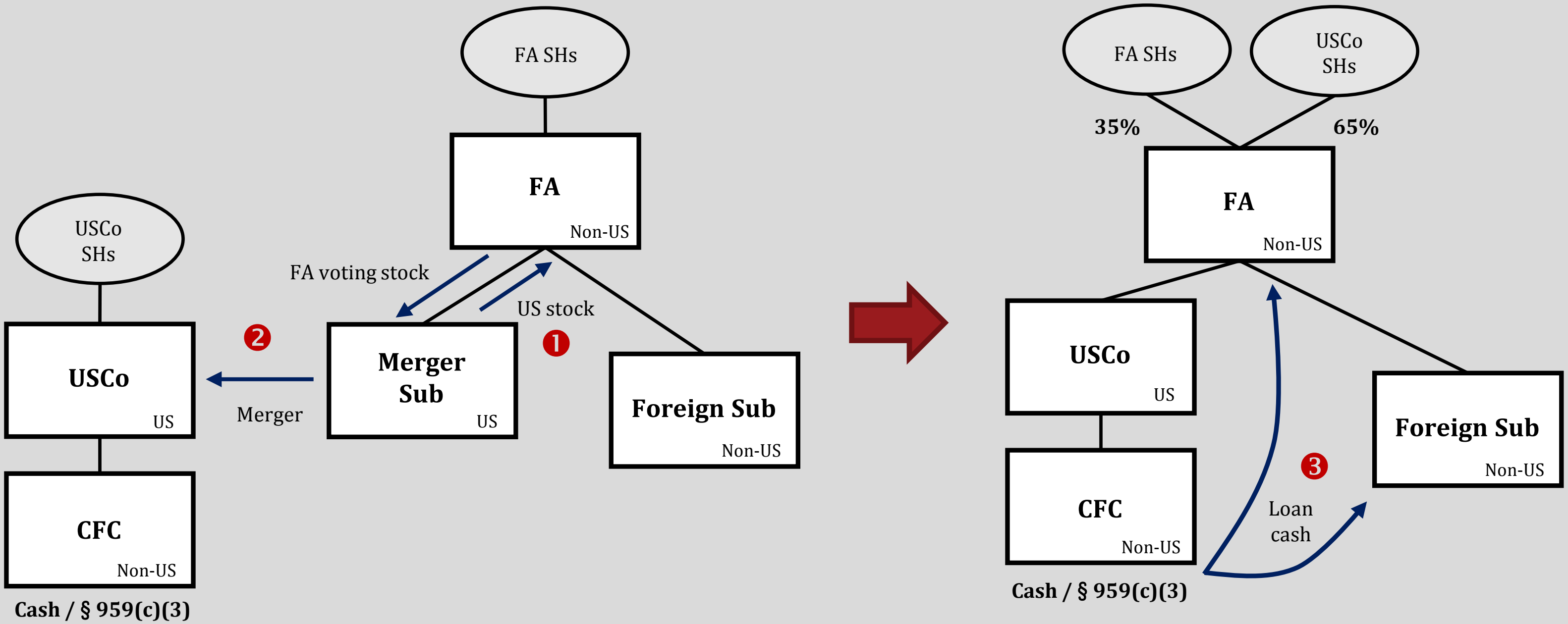
"SPINVERSION" RULES (FOREIGN-PARENTED)



Notice § 2.03 – Foreign-parented group

- *Relevant authority* – § 7874(c)(2)(A) (statutory EAG rule)
- *Background* – § 7874(c)(2)(A) provides that FA stock held by members of the EAG is not included in numerator or denominator, so normally a contribution of all DC shares to a new FC would not trigger § 7874 b/c the ownership fraction is 0/0 after applying statutory EAG rule. It does not always yield the correct results, so the regs contain exceptions to it that exclude stock from numerator but not denominator – see (1) internal group restructuring, and (2) loss of control. See Reg. § 1.7874-1(c)(2)-(3). The –5T regs address the impact on numerator where (1) former DC SHs receive FA stock *(cont'd)*
- *(cont'd)* by reason of holding stock in DC, and (2) thereafter transfer that FA stock; the subsequent disposition of the "by reason of" stock generally does not kick that stock out of the numerator, unless it is excluded from fraction by EAG rules. A preamble warned of potential issues with divisive § 355 txns
- *Notice rule* – FA stock received by former corp SH of DC and subsequently transferred in related transaction will not be considered held by member of EAG for purposes of applying the EAG rules (thus, the FA stock is included in numerator and denominator) UNLESS (1) *before* the acquisition, both the transferring corp and the domestic entity are members of the same foreign-parented group, and (2) post-acquisition, the transferring corp is (or would've been) a member of the EAG

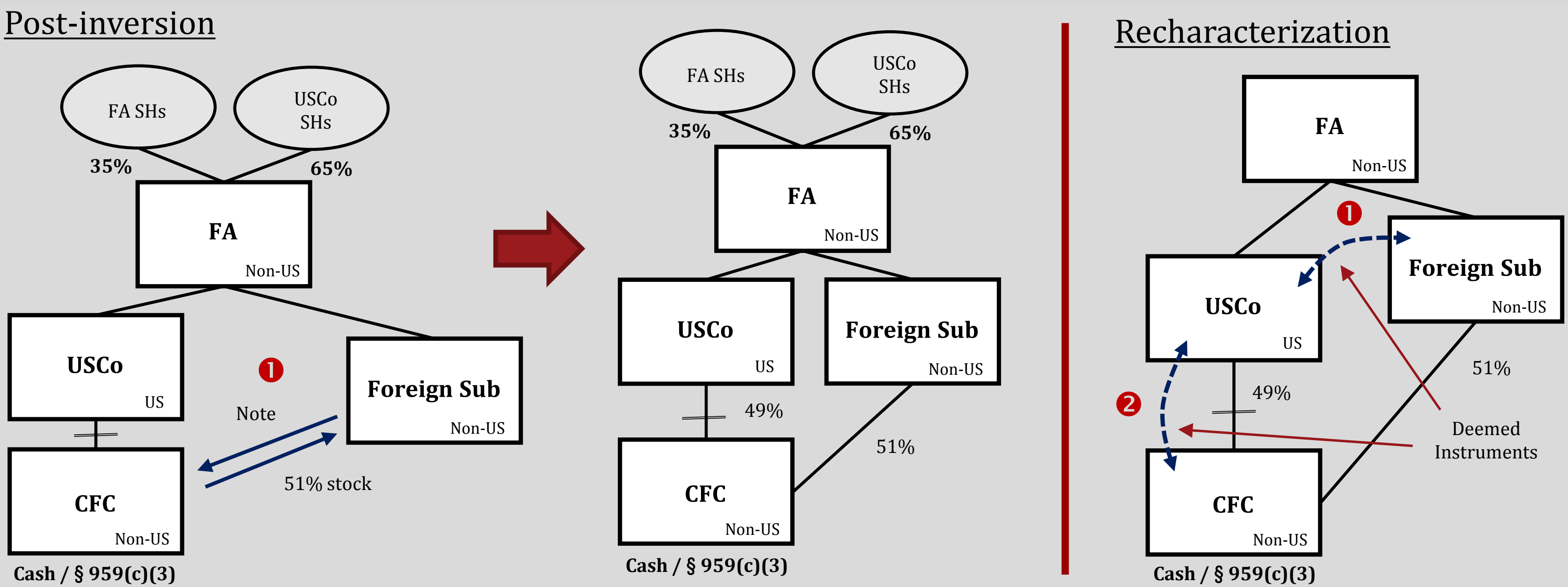
The New "US Property" Rules



Notice § 3.01 – New "US property" rules

- *Relevant authorities* – § 956(c)(1)-(2), § 956(e)
- *Background* – § 956(c) specifically defines "US property" and exceptions thereto, but § 956(e) grants T/IRS the authority to write rules as necessary to prevent the avoidance of § 956 "through reorganizations or otherwise." T/IRS are concerned that an "inversion" may permit the top corporate parent to access deferred earnings of a CFC, even though that could not have been achieved prior to the transaction; thus, the reorg seems to present an opportunity to circumvent § 956 purposes
- *Notice rules* – Solely for purposes of § 956, any obligation or stock of a foreign related person (other than an "expatriated foreign subsidiary" ("EFS"), meaning a CFC in which the "expatriated entity" is a USSH) will be treated as "US property" to the extent acquired by an EFS during the 10-year period noted in § 7874. Pledgor/guarantor rules are also contemplated. Note: an EFS does not include a CFC that is a member of the EAG immediately after the deal if the domestic target is not a USSH with respect to that CFC on or before the completion date
- *Additional notes* – Comments re rule exceptions requested, but Notice 88-108 will not supply an exception to obligations here

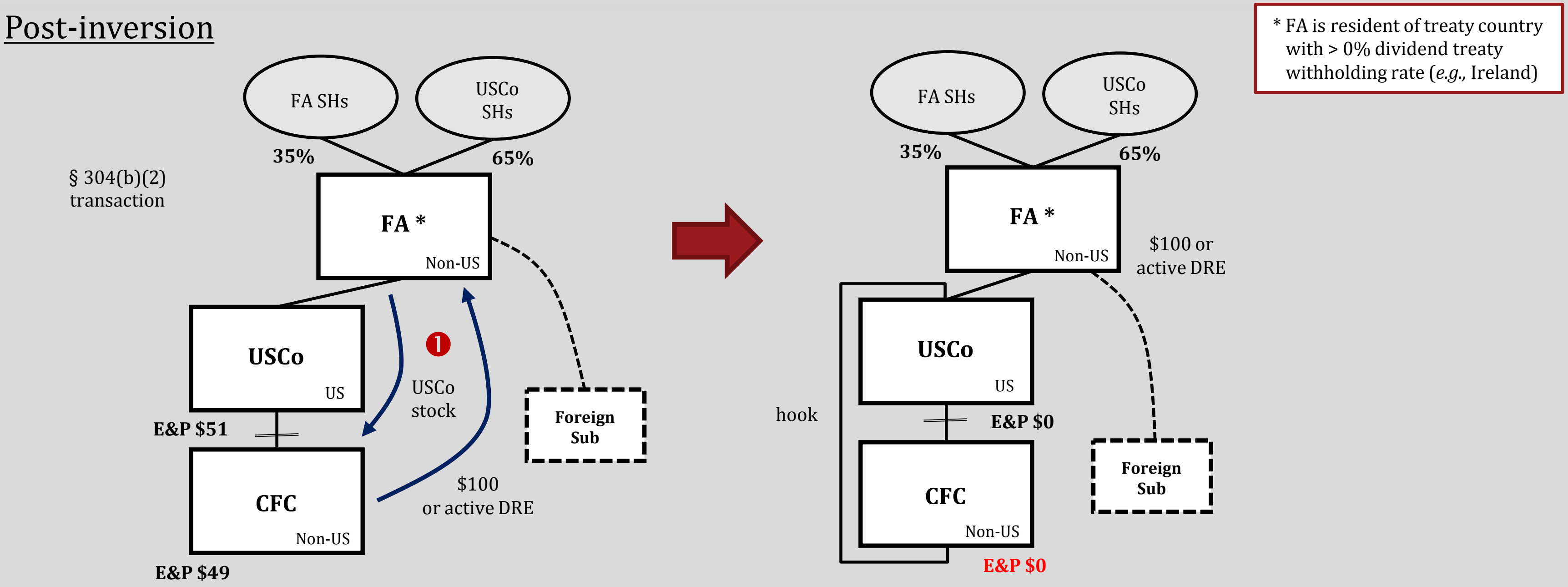
De-controlling / Dilutive Transactions



Notice § 3.02 – De-controlling / dilution

- *Relevant authorities* – § 7701(l), § 367(b), § 964(e), § 954(c)(6)
- *Background* – § 7701(l) states that T/IRS may write regulations to recharacterize "any multiple-party financing transaction as a transaction directly among any 2 or more of such parties" if appropriate to prevent tax avoidance. § 964(e) provides for § 1248-like consequences where a CFC sells/exchanges stock in a foreign corp, and the § 367(b) regs essentially trigger tax if § 1248 cannot be protected in a F2F txn. T/IRS concerned that after an "inversion" the group might try to de-control a CFC in order to access the CFC's deferred earnings
- *Notice rules* – T/IRS will issue regs under § 7701(l) to provide that a "specified transaction" (a "ST") completed during the 10-year period noted in § 7874 will result in a recharacterization of the txn (for all purposes of Code) as an arrangement directly between a "specified related person" (e.g., a non-CFC foreign related person) and 1+ USSHs of the EFS. (Note: A ST is a txn in which stock of an EFS is transferred/issued to a "specified related person.") The deemed instruments terms will generally mirror those of the disregarded stock. No recharacterization if (1) full recognition / inclusion of all gain / deemed dividends is otherwise triggered, or (2) post-ST the EFS remains a CFC and the aggregate USSH dilution is not more than 10%. Other rules to provide that § 954(c)(6) inapplicable to any deemed dividend resulting from a ST. Further, § 367(b) regs will be redrafted to require income inclusions in certain dilutive NR txns (a big deal!)

The § 304 Rule



Notice § 3.03 – A new § 304 rule

- *Relevant authority* – § 304(b)(5)(B), § 304(b)(5)(C)
- *Background* – § 304(a)(1) provides that if persons control each of 2 corps and, in return for property, the acquiring corp acquires stock in the target corp from the persons in control, then the property is treated as distributed in redemption of the acquiring corp's stock. § 304(a)(2) provides that if acquiring corp, in return for property, acquires target stock from a SH of target, and target controls the acquiring corp, then the property is treated as distributed in redemption of the target corp's stock. § 304(b)(2) provides that E&P is sourced from acquiring, then target. § 304(b)(5)(B) limits the E&P taken into account if acquiring corp is foreign – specifically, *(cont'd)*
- *(cont'd)* E&P of the acquiring corp is not used if more than 50% of the dividends arising from such acquisition neither immediately subject to US tax nor included in a CFC's E&P. Essentially attempts to prevent foreign acquiring corp's E&P from escaping US tax by being deemed distributed directly to a foreign person (transferor) without hitting a US tax-relevant person. T/IRS believe taxpayers may interpret § 304(b)(5)(B) as inapplicable if more than 50% of the dividend is sourced to the domestic corporation (e.g., subject to reduced WHT). § 304(b)(5)(C) gives T/IRS authority to issue regs.
- *Notice rules* – T/IRS will issue regs providing that for purposes of applying § 304(b)(5)(B), the "more than 50%" evaluation (testing whether subject to tax or includible in a CFC's E&P) is made by taking into account *only* acquiring corp's E&P (i.e., CFC in example above)

Notice 2014-52: Final Points

Final summary

- Generally uses the current § 7874 threshold for SFCs (<u>at least 60%</u>) to define "inversions"
- Notice provisions generally only apply where there is an "inverter," except for § 304 rule
- September 22, 2014 is the anchor date
- Taxpayer-friendly *Foreign-Parented Group Rule* can be applied prior to September 22, 2014
- **Future guidance**
  - T/IRS anticipate issuing future guidance to further limit inversion transactions and benefits thereof
  - Specifically contemplating earnings-stripping guidance (e.g., intercompany debt, low-tax countries)
  - Comments are requested on a number of items
  - *In terrorem* clause:

> ***Future guidance will apply prospectively; however, the Treasury Department and the IRS expect that, to the extent that any <u>tax avoidance guidance</u> applies <u>only</u> to inverted groups, such guidance will apply to groups that completed inversion transactions on or after September 22, 2014***
>
> **– Notice 2014-52 § 5**

Notice 2015–79

Overview of Notice 2015-79

Notice 2015-79

- Treasury/IRS issued Notice 2015-79 against a backdrop of large-scale cross-border M&A activity; it follows in the footsteps of, and is similar in reach to, Notice 2014-52.
- **Framework of Notice**
  - **Overview (Notice § 1)**
  - **Regulations to address transactions structured to avoid § 7874 purposes (Notice § 2)**
    - SBA test – tax residency requirement (§ 7874) – § 2.02(a)
    - Ownership test – FT / new FA aligned tax residency requirement (§ 7874) – § 2.02(b)
    - Ownership test – anti-stuffing rule (FA) / clarification of "avoidance" property (§ 7874) – § 2.03
  - **Regulations to address post-inversion tax avoidance transactions (Notice § 3)**
    - "Inversion gain" – to include indirect transfers/transactions w/r/t specified foreign persons (§ 7874) – § 3.01
    - Dilution / de-control transactions – § 1248 pickup *and* all stock gain triggered (§ 7701(l) / § 367(b)) – § 3.02
  - **Corrections / clarifications to Notice 2014-52 rules (Notice § 4)**
    - Anti-cash-box rule – revised definition of "foreign group non-qualified property" (insurance cos) – § 4.01
    - Anti-slimming (NOCD) rule – inclusion of de minmis exception – § 4.02
    - Dilution / de-control rule – clarifying the small dilution exception computation – § 4.03
  - **Effective dates (Notice § 5)**
  - **Request for comments / continuing consideration of additional guidance (Notice § 6)**

Overview of Notice 2015-79 (cont.)

Authority / support for rules

- Notice § 2.01 makes the following points in support of authority to promulgate rules:

§ 7874(c)(4)

The transfer of properties or liabilities (including by contribution or distribution) <u>shall</u> be disregarded if such transfers are <u>part of a plan</u> <u>a principal purpose</u> of which is <u>to avoid the purposes of this section</u>

§ 7874(c)(6)

The Secretary shall prescribe such regulations <u>as may be appropriate</u> to determine whether a corporation is a [SFC], including regulations – (A) to treat warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock, and (B) <u>to treat stock as not stock</u>.

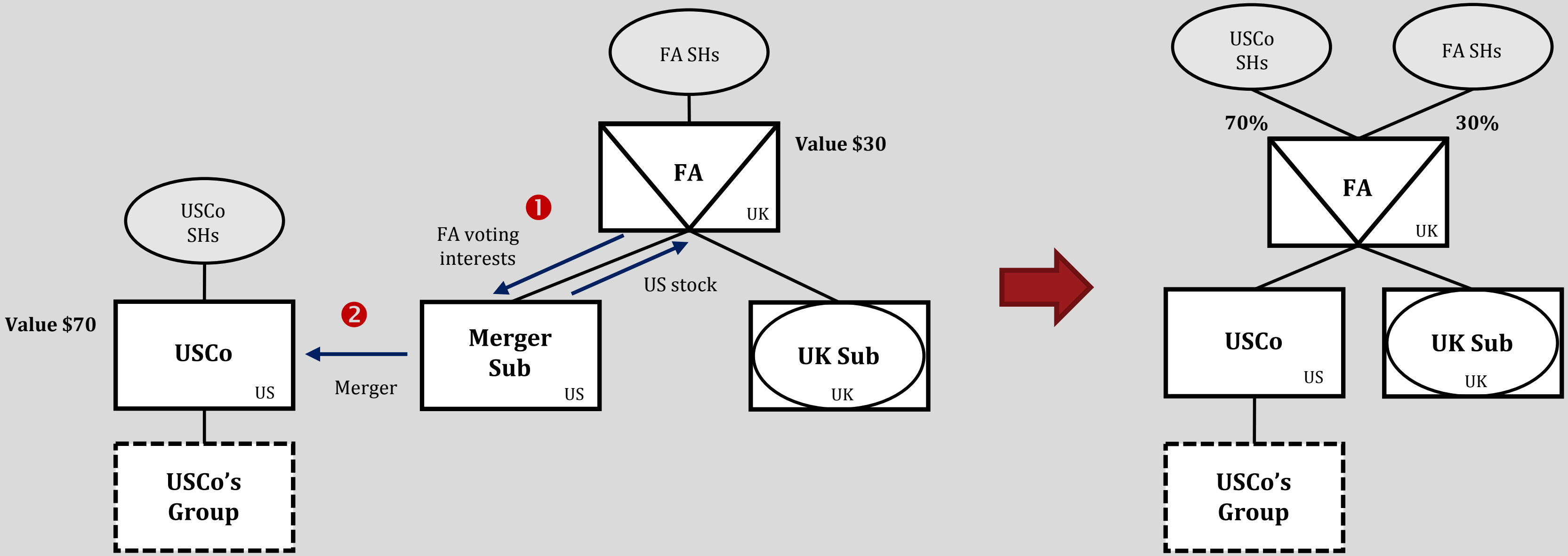
§ 7874(g)

The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through – (1) the use of related persons, pass-through or other non-corporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of the [EAG] or related persons.

2003 legislative history (Senate)

Congress enacted § 7874 because it believed that "inversion transactions <u>resulting in a minimal presence in a foreign country of incorporation</u> are a means of avoiding U.S. tax and should be curtailed."

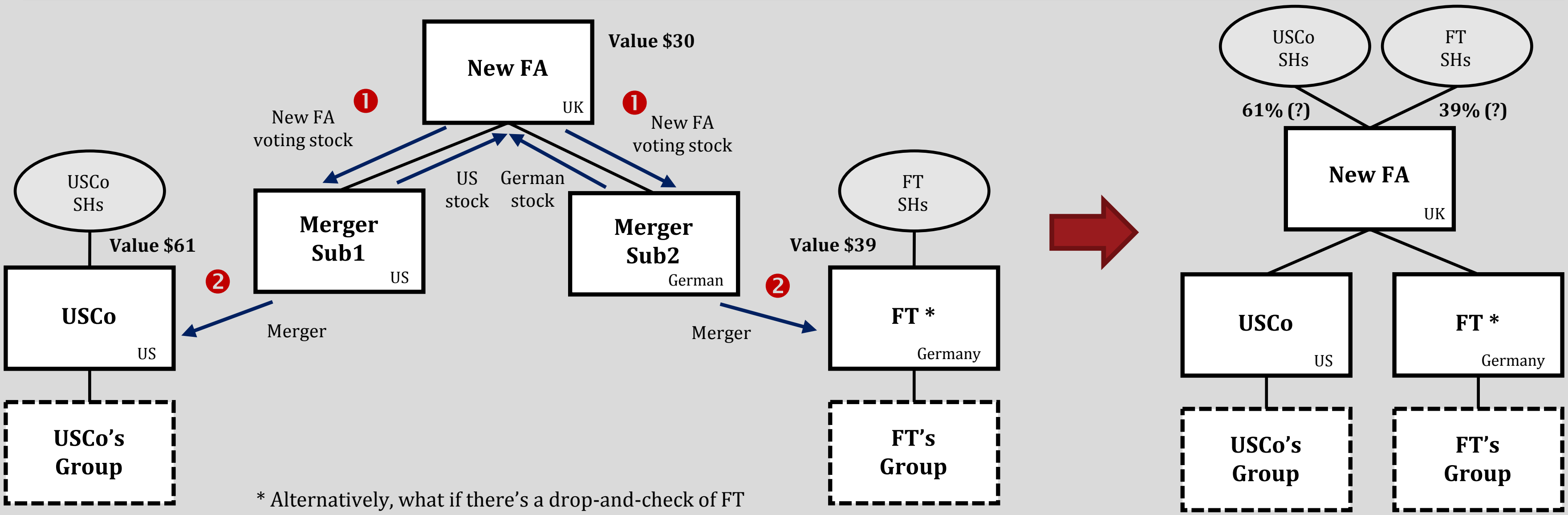
SBA Test – Tax Residency Requirement



Notice § 2.02(a) – <u>SBA residency requirement</u>

- *<u>Relevant authorities</u>* – presumably § 7874(c)(6), § 7874(g)
- *<u>Background</u>* – § 7874(a)(2)(B)(iii) (SBA prong) effectively provides that FA will not be a SFC if, after the acquisition, its EAG has substantial business activities "in the foreign country in which, or under the law of which, the entity [i.e., FA] is *created or organized*…" Originally, the SBA test was based on facts / circ. evaluation (but with a 10% safe harbor threshold); in mid-2009, T/IRS removed the safe harbor; in mid-2012, T/IRS removed any facts / circ. evaluation and mandated a 25% bright-line test
- *<u>Notice view</u>* – T/IRS believe that the policy underlying the SBA test exemption is premised on FA being subject to tax as a resident of its country (i.e., § 7874's reference to country of creation/organization "reflects the US standard for determining tax residency"). The US tax residency std doesn't always align with that of foreign countries; giving a pass via SBA w/o requiring tax residency in FA's country means US tax residency could be given up for non-FA tax residency (or even no tax residency); CTB rules facilitate
- *<u>Notice rules</u>* – the SBA test cannot be satisfied unless FA is <u>also</u> a <u>tax resident</u> in its country

Ownership Test – Tax Residency Rqmt.

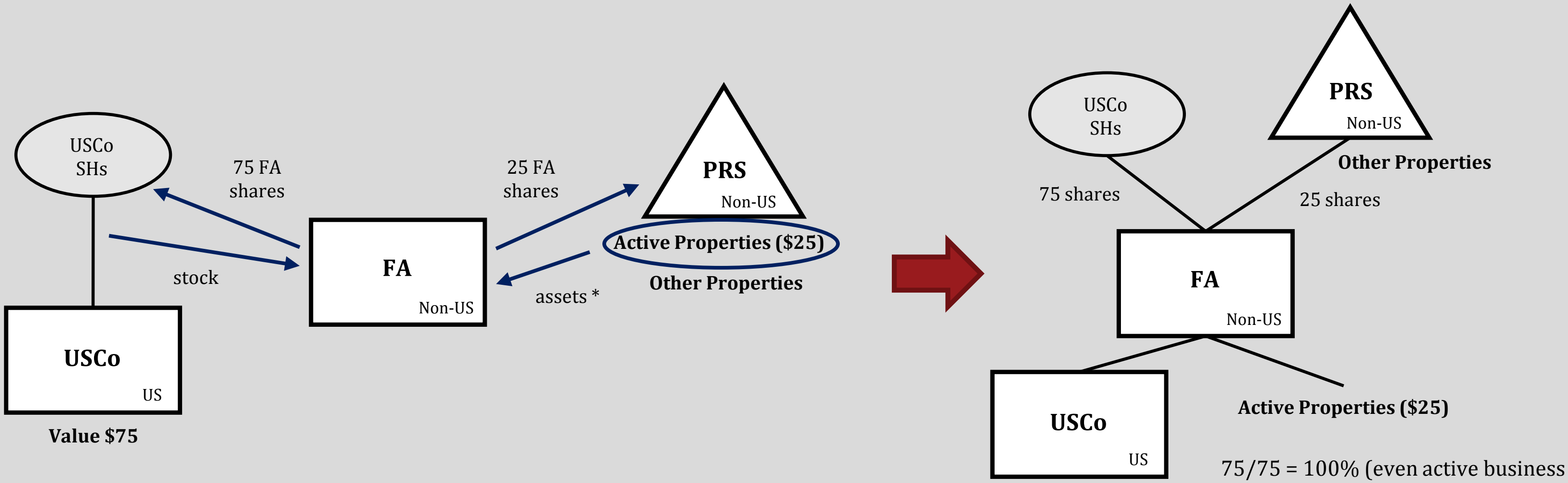


* Alternatively, what if there's a drop-and-check of FT into UK Co immediately before the transaction?

Notice § 2.02(b) – Ownership residency rqmt.

- *Relevant authorities* – § 7874(c)(6), § 7874(g)
- *Background & Notice view* – T/IRS note in certain cases the Congress thought that UST's replacement by a new FP will have little/no non-tax purpose and should be disregarded (e.g., 80% threshold). T/IRS think that if stock issued in txn where new *3rd country FP* inserted, inserting the new tax residence via the new FP generally is driven by tax planning and US tax avoidance motives (e.g., lower WHT or better local/CFC system to better base erode US); accordingly, rules will attempt to shut down/police this apparent abuse
- *Notice rules* – Will disregard certain stock of new FA issued to SH of *existing FT* (i.e., that stock will be excluded from the denominator if held by former FT SHs *by reason of* holding FT stock) if a four-part (conjunctive) test is met:
  1. **FT Acquisition (Sub-All).** In a txn related to the DT acquisition, new FA directly or indirectly acquires "sub all" of FT's properties [Note special rule];
  2. **Tax Residence.** New FA tax residence not same as that of FT (determined right before FT acquisition and any txn related to FT acquisition, including a change of management/control of FT);
  3. **60-80% Threshold.** Absent these rules, DT SHs own 60% to < 80%; AND
  4. **Gross Value.** GV of all property directly/indirectly acquired by new FA in the FT acquisition exceeds 60% of GV of all "foreign group property"

Anti-Stuffing (FA) – "Avoidance Property"



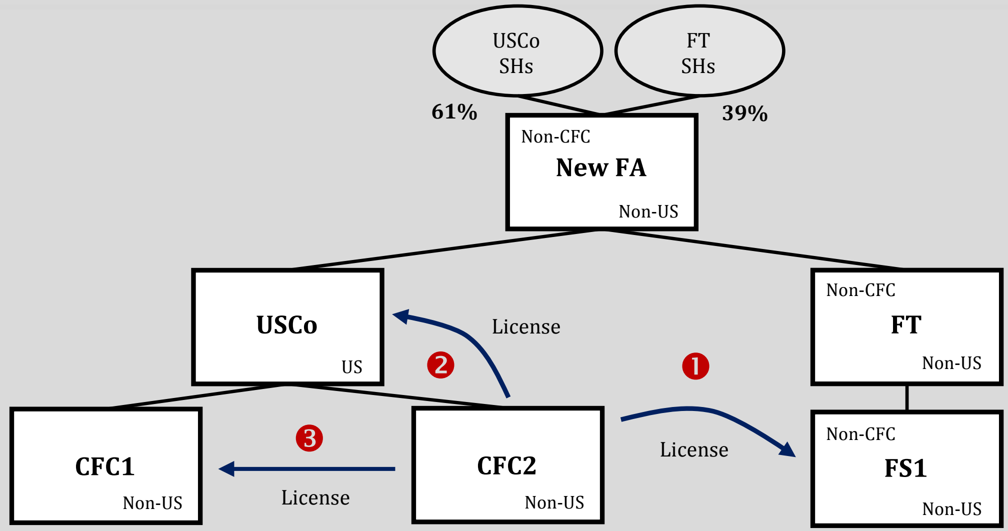
* Assume a tainted purpose

Notice § 2.03 – <u>Avoidance property (clarified)</u>

- *<u>Relevant authorities</u>* – § 7874(c)(2)(B), § 7874(c)(6)
- *<u>Background</u>* – § 7874(c)(2)(B) and Reg. § 1.7874-4T say that "disqualified stock" (DS) isn't in the denominator in running ownership test. DS is stock of FA transferred in exchange for "nonqualified property," including (1) cash or equiv., (2) marketable securities (other than equity in an entity that becomes a member of EAG), (3) certain obligations, or (4) any other property acquired in txns related to DT acquisition and w/ a principal purpose of avoiding § 7874 purposes ("avoidance property")
- *<u>Notice view</u>* – T/IRS believe that taxpayers are too narrowly interpreting "avoidance property" (e.g., as property, such as stock, *used to indirectly transfer* DS items 1-3 to FA); this interpretation is inconsistent w/ plain language/purpose of Reg. § 1.7874-4T; also § 7874(c)(6) also disregards transfers of property if part of plan a principal purpose of which is to avoid § 7874 purposes
- *<u>Notice rules</u>* – the regs will be "clarified" to provide that "avoidance property" includes *any* property (other than DS items 1-3) acquired w/ a principal purpose of avoiding the purposes of § 7874 *regardless* of whether txn involves an indirect transfer of DS items 1-3

Inversion Gain – Indirect Items

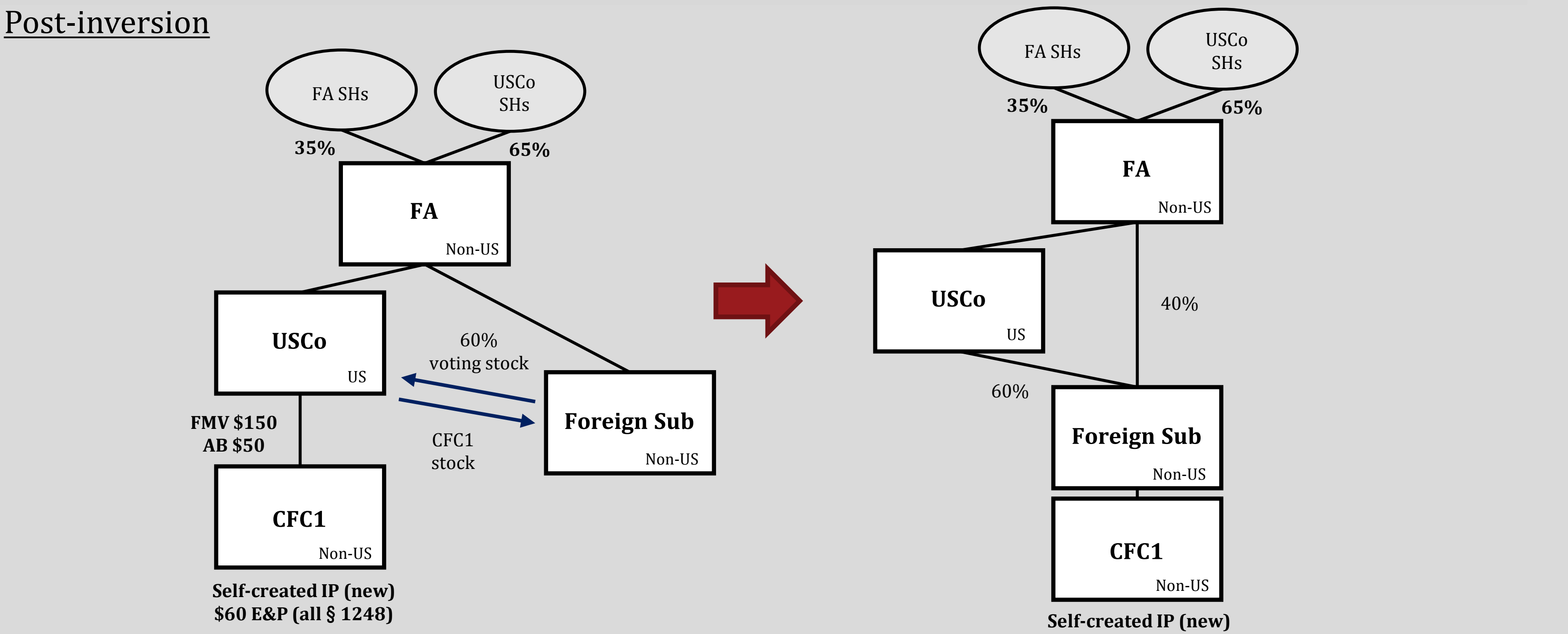
Post-inversion



Notice § 3.01 – Inversion gain – Indirect Items

- *Relevant authorities* – § 7874(a)(1), § 7874(e)(1), § 7874(g)
- *Background* – § 7874(a)(1) provides that TI of "expatriated entity" for 10 year post-inversion shall not be less than the "inversion gain." § 7874(d)(2) defines inversion gain as (1) any income/gain recognized due to a transfer of stock/property during the period by an expatriated entity, or (2) any income received/accrued during period by reason of a license of property by an expatriated entity either (a) as part of the DT acquisition, or (b) after the txn if the transfer/license is to a foreign related party. § 7874(e)(1) also suggests that § 902 credits should generally not be available to offset inversion gain
- *Notice view* – T/IRS believe that *indirect* transfers are not caught, but should be caught in order to preserve purposes of § 7874 (i.e., to put toll charge on post-inversion txns that are designed to remove income from foreign ops from US tax, e.g., by limiting use of ability to offset w/ attributes). If *direct* txns by the expatriated entity are caught, then the *indirect* txns (e.g., txns done by CFC owned by expatriated entity) should also be caught – i.e., no subpart F offsets
- *Notice rules* – inversion gain includes income/gain recog. by and expatriated entity due to an *indirect* transfer/license of property (e.g., by CFC) either (1) as part of DT acquisition, or (2) post-inversion if transfer/license is to "specified related person" (e.g., a non-CFC foreign related person)

Dilution / Etc. – Full-Gain Pickup



Notice § 3.02 – <u>Dilution, etc. – full gain pickup</u>

- *<u>Relevant authorities</u>* – § 367(b), Notice 2014-52
- *<u>Background</u>* – Notice 2014-52 § 3.02 already provided rules that would trigger § 1248 inclusions where there were dilutive / decontrolling transactions involving CFCs in a post-inversion era. However, the net result was to require a pickup of the § 1248 amount, which could be a material amount (or not) based on the CFC's posture
- *<u>Notice rules</u>* – T/IRS continue to be concerned that these dilutive / decontrolling transactions may still allow the US shareholder to avoid US tax on unrealized appreciation in CFC property (e.g., new valuable self-developed IP that has not yet been exploited) where unrealized gain on stock exceeds § 1248 amount. Not taxing such gain on a post-inversion transaction raises policy issues under § 7874. So, T/IRS will amend the Notice 2014-52 § 367(b) regs to say that if required to include § 1248 amount w/r/t stock of EFS, must *also* recognize *all* realized gain w/r/t that stock

Correct / Clarify Prior Notice

Notice 2015-79 provides corrections / clarifications to Notice 2014-52

- **Anti-cash box rule – definition of "foreign group nonqualified property" (Notice § 4.01)**
  - *Favorable change for insurance companies* – Notice 2014-52's anti-cash box rules generally provided that if more than 50% of the gross value of all "foreign group property" is "foreign group non-qualified property" (FGNP), then part of FA stock would be excluded from the denominator of ownership test. Certain insurance companies were not happy that the rule did not exclude from FGNP property giving rise to income described in the § 1297 PFIC insurance exception. Similarly, there was concern that FGNP could cover property held by a DC engaged in an active banking or insurance business (e.g., FA held DC stock in such business prior to the transaction). T/IRS will write rules to more favorably account for these concerns, but will be cautious nonetheless
- **Anti-sliming (NOCD) rule – inclusion of a de minimis exception (Notice § 4.02)**
  - *Favorable change for anti-sliming rule* – Notice 2014-52 had a pretty broad rule disregarding certain distributions made by a domestic entity before being acquired by FA. Commenters were concerned that this could mean § 7874 would apply even though former owners of DT own no / de minimis amount of FA stock post-acquisition. T/IRS will write rules to allow for a de minimis exception where (1) the ownership percentage generally is < 5% (vote and value), and (2) after the acquisition, former SHs must own in aggregate (incl. through modified § 318 attribution) < 5% (vote and value) of any member of EAG. If met, no distributions will be treated as NOCD that are disregarded; however, T/IRS will still disregard distributions that have as a principal purpose the avoidance of § 7874
- **Dilutive / de-controlling rules – (Notice § 4.03)**
  - *Clarifications to methodology for computing small dilution exception* – Notice 2014-52 generally provided a small dilution exception where (1) and expatriated foreign subsidiary (EFS) is a CFC immediately after the "specified transaction" and all related transactions, and (2) the amount of stock (by value) in the EFS owned (in aggregate) by § 958(a) US SHs of EFS immediately before the specified transaction and any transactions related thereto does not *decrease* by more than 10% as a result of the specified transactions and related transactions. T/IRS were concerned that people were improperly determining/computing this exception, and will provide clarifications in the regs that are released

Notice 2015-79: Final Points

Effective dates

- The two **tax residency rules** (i.e., under the SBA and ownership tests) apply to acquisitions completed on/after Nov. 19, 2015
- The **anti-stuffing rule (FA)** (i.e., clarification of "avoidance" property) applies to acquisitions completed on/after Nov. 19, 2015
- The changes to the **anti-cash box** and **anti-slimming (NOCD) rules** apply to acquisitions completed on/after Nov. 19, 2015 (although can elect to apply the changes to acquisitions completed prior to that date)
- The **indirect inversion gain rule** applies to transfers / licenses of property occurring on/after Nov. 19, 2015 (but only if the inversion is completed on/after Sept. 22, 2014)
- The **dilutive / de-control rule and clarification** (i.e., the full stock gain pickup rule under § 367(b) regs, and the clarification re: interpretation of small dilution exception) apply to specified transactions or specified exchanges occurring on/after Nov. 19, 2015 (but only if the inversion is completed on/after Sept. 22, 2014)

- **Future guidance**
  - T/IRS anticipate issuing future guidance to further limit (1) inversion transactions contrary to the purposes of § 7874, and (2) the benefits of post-inversion tax avoidance transactions
  - Specifically contemplating earnings-stripping guidance (e.g., intercompany debt, low-tax countries)
  - Comments are requested on a number of items

Thank you…

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