PENN STATE LAW
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SLIDES ILLUSTRATING (1) A PROTOTYPICAL INVERSION TRANSACTION, AND (2) THE IMPACT OF TREASURY AND IRS NOTICE 2015-79
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**Prototypical Inversion Transaction**

**Slide #1 Pre-Transaction Structure**

- **Entity Key**
  - Corporations =
  - Shareholders =

- **New Foreign Holding Company**
  - **Public Shareholders**
    - **U.S. Acquirer Aka: “Domestic Inverter”**
      - Its shareholders end up with more than 50% of the stock of the New Foreign Holding Company.
    - **U.S. Merger Sub**
    - **Foreign Amalgamation Sub**
    - **Foreign Inversion Target**
      - Its shareholders end up with less than 50% of the stock of the 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 = CFC, Aka: “DI’s CFC #1” (Deferred “Trapped” Foreign Earnings)***
  - **Controlled Foreign Corporation #2 = CFC, 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-TRANSACTION STRUCTURE

New Foreign Holding Company

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

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

[2a] RSM

New Foreign Holding Company

Public Shareholder

Domestics Inverter

U.S. Merger Sub

Foreign Amalgamation Sub

Foreign Inversion Target

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 § 15B74, 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.
**TREASURY NOTICE 2015-79: IMPACT ON INVERSION STRUCTURE**

**SLIDE # 5 THIRD-COUNTRY TRANSACTION, § 2.02(b), EXAMPLES 1 AND 2**

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$\text{§ 2.02(b) disregards stock of the New Foreign Holding Company that is issued to the shareholders of the Foreign Inversion Target for the purpose of determining whether the 80% threshold is met.}$

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[Diagram Description]

**The Old Shareholders of Domestic Inverter**

[65 FHC shares]

**New Foreign Holding Company (FHC) = a Domestic Corp**

(A tax resident of Country Y)

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

**Domestic Inverter (DI)**

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**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.]

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*Note: Even if FIT, before it is acquired by FHC, reincorporates in Cty Y and becomes a tax resident of Cty Y, § 2.02(b) still applies. *See Exp 2.*
TREASURY NOTICE: IMPACT ON INVERSION STRUCTURE

SLIDE # 6 ANTI-STUFFING RULES STRENGTHENED, §2.03

§ 2.03 of Notice 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.

[Diagram showing the flow of shares and ownership percentages.]

[Ownership Percentage: 75 / (100 - 25) = 100%]
$2.02(a)$ of Notice requires that for an Expanded Affiliate Group (EAG) to have substantial business activities in the relevant foreign country when compared to the EAG's total business activities, the foreign acquiring corporation must be subject to tax as a resident of the relevant foreign country.
TREASURY NOTICE: POST-INVERSION TAX AVOIDANCE
SLIDE # 8 DEFINING INVERSION GAIN, § 3.01

Old Public Shareholders of Domestic Inverter

51% - 79%

Old Public Shareholders of Foreign Inversion Target

21% - 49%

New Foreign Holding Company (FHC)

Domestic Inverter (DI)

Foreign Inversion Target

DI's CFC #1

DI's CFC #2

§ 3.01 of Notice provides that inversion gain includes income or gain recognized by DI from an indirect transfer or license of property, either (i) as part of the acquisition, or (ii) after such acquisition if the non-inventory transfer or license is to a specified related person.

[After the acquisition, a CFC sells non-inventory property to FHC, as a result, realizing $100x, gross income.]
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

A (B) Reorganization under §368(a)(1)(B)

DI's CFC #1 Also=FT

DI's CFC #2

Foreign Inversion Target Also=FS

Under § 3.02, DI must include the $60x in income as deemed dividend, i.e., the § 1248 amount.

Also, 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.
TREASURY NOTICE: IMPACT ON INVERSION STRUCTURE

SLIDE #10 ANTI-CASH BOX RULE, § 2.01 OF 2014 NOTICE

§ 2.01 of Notice 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.

New Foreign Holding Company (FHC)

Public Shareholders

Domestic Inverter

U.S. Merger Sub

Foreign Amalgamation Sub

Public Shareholders

Foreign Inversion Target

DI's CFC #1

DI's CFC #2
In Notice 2014-52, IRS limited the ability of companies to count passive assets that aren’t part of daily business functions to inflate the new foreign parent’s size (the “cash box” rule).

In Notice 2015-79, IRS has corrected the cash box rule to (i) ensure that assets used in an active insurance business (that give rise to income described in Code Sec. 1297(b)(2)(B)) are not treated as passive assets, and (ii) provide that the general definition of foreign group nonqualified property generally does not include property held by a domestic corporation taxed as an insurance company.
§ 2.02 of Notice 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.
TREASURY NOTICE: CLARIFYING CHANGES TO NOTICE 2014-52
SLIDE # 13 DE MINIMIS EXCEPTION, § 4.02

§ 2.02 of Notice 2014-52, will disregard certain "slimming down" distributions by DI 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.

2015 Notice Clarifies the De Minimis Exception to § 2.02 of Notice 2014-52, by adding the following two conditions:
1. Ownership percentage less than 5% and
2. After the transaction, old shareholders of DI own less than 5% of the stock of any member of EAG.

Diagram:
- New Foreign Holding Company (FHC)
  - Public Shareholders
  - Domestic Inverter
    - DI's CFC #1
    - DI's CFC #2
  - U.S. Merger Sub
  - Foreign Amalgamation Sub
    - Foreign Inversion Target
  - Public Shareholders
This diagram illustrates the anti-decontrol of CFC rule, § 3.02 (e) (i) of 2014 inversion notice. The key points are:

1. Old Public Shareholders of Domestic Inverter and Old Public Shareholders of Foreign Inversion Target.
2. New Foreign Holding Company (FHC).
3. Domestic Inverter (DI) and Foreign Inversion Target.
4. DI’s CFC #1 and DI’s CFC #2.

Under § 3.02 (e) (i) of Notice, 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.
§ 4.03 will clarify the application of the small dilution exception by substituting the phrase "the percentage of stock (by value)" for the phrase "the amount of stock (by value)." A similar clarification will be made to the exception described in section 3.02(e)(ii) of Notice 2013-52 (relating to the circumstances in which an exchanging shareholder is required under section 367(b) to include in income as a deemed dividend the section 1248 amount with respect to stock exchanged in a specified exchange).

The small dilution exception is not applicable because the amount of CFC #2's stock (by value) that is owned (within the meaning of section 958(a)), in the aggregate, by DI before the specified transaction decreases by more than 10 percent (in fact, by 60 percent from 100 percent to 40 percent) as a result of the specified transaction.