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New Treasury Rules A Blow To Inversions But Not Fatal

By **Karlee Weinmann**

Law360, New York (September 23, 2014, 5:44 PM ET) -- The U.S. Department of the Treasury has started its long-anticipated crackdown on tax-motivated mergers and acquisitions, but restrictions leveled this week don't address one key driver behind so-called inversions, leaving deal makers room — at least for now — to work around the new rules and keep the controversial transactions coming.

A notice from the agency on Monday marked the Obama administration's toughest attack yet on inversions, cross-border mergers that shift U.S. parties' legal homes to tax-friendly jurisdictions abroad. The structure has exploded in popularity this year, fanning concerns in Washington, D.C., that a corporate exodus could sap U.S. tax coffers.

New Treasury restrictions are meant to "significantly diminish" inversion prospects, Treasury Secretary Jacob Lew said. But tax and M&A attorneys say they don't go far enough to pinch off the tidal wave of interest in the deal structure.

"While the notice will present challenges for some U.S. companies seeking to invert, most companies should be able to navigate the notice and complete a successful inversion with proper planning," attorneys from Cadwalader Wickersham & Taft LLP wrote in a Tuesday note.

The rules, effective for inversions not closed as of Monday, make it harder for companies to skirt around stateside stock ownership requirements. They also prevent companies from using inversions to dodge U.S. taxes on their existing foreign earnings, including a prohibition on alluring "hopscotch loans" that allow companies to bypass U.S. taxes when they access their offshore cash.

But not all transactions hinge on hopscotching. Inverted companies can still tap into what Sen. Charles Schumer, D-N.Y., has identified as the top incentive driving inversions in recent months: earnings stripping.

The maneuver allows companies to shave future U.S. tax bills when their foreign parent provides a loan with deductible interest, and the deductions offset some or all of the taxes owed to the U.S. The Treasury warned this week it could take specific action to clamp down on earnings stripping but left the controversial tactic alone for now.

"The notice will have the effect of deterring some transactions but clearly not all," said Gary Friedman, a tax partner at Debevoise & Plimpton LLP. "There would be modest deterrent effect on earnings stripping transactions, but there would be a significant deterrent on transactions that depend on accessing

offshore cash."

Despite the opening left for inversions, the Treasury's efforts to peel back benefits will sink some inversions, attorneys said, potentially including ones already announced but not yet closed.

Some deal watchers predict the developments could put a freeze on inversion interest until the parameters become more clear, especially considering campaigns underway in Congress to stem the outflow of U.S. companies and the Treasury's hint that it would impose further restrictions down the line.

Monday's notice, including its emphasis on hopscotch loans, makes clear the administration is willing to go as far as it can to halt inversions, Hogan Lovells partner Jason Kaplan said.

"This kind of guidance might have come out in bits and pieces over time, but instead, it's all together in a very comprehensive package," he said. "They used their broad anti-avoidance authority to deal with each of those variations so that short-term benefits in many cases won't be there."

Still, there is more propelling inversions than the potential to cut taxes on foreign earnings. Virtually every transaction is buoyed by other factors, including the standard M&A promises of synergies and expansion, reinforcing inversions' broader appeal and suggesting deal makers will be slow to back off the structure altogether.

"One variable or maybe a couple of variables that may have been factors will have to be evaluated in a new light," said Jason Bazar, co-chairman of the tax transactions and consulting practice at Mayer Brown LLP. "I don't think these deals are ever done based on just one or two factors, certainly not just one or two tax factors. There's too much going on."

Still, moving forward, the new rules — and the specter of more to come — could change the game by eroding the premiums so far placed on inversions. A theme of high payouts for the non-U.S. company's stockholders can be found in the inversion agreements inked to date, primarily a reflection of the substantial tax benefits, sometimes totaling billions of dollars, believed to be attached to the deals.

"It's fair to say the shareholders of the foreign entities do quite well in these inversion transactions because there's so much U.S. tax savings on the table," Friedman said. "The foreign companies know it so they negotiate a favorable exchange ratio for their shareholders."

But where the new rules could limit the perceived tax payoff in such deals, it could also cut into the considerations attached to them. The foreign companies will have less leverage to demand exchange ratios that skew heavily in their favor, shaking up the dynamics that have underpinned a bulk of inversions so far.

On a broader scale, the new risk profile could reshuffle the way companies approach inversions — and cross-border deal-making in general.

"Nobody is forced in these deals to engage in a tax-reduction plan, so if it makes a lot of business sense to combine two companies, they will just not undertake the hopscotch loans, or they'll pay the U.S. tax bill, and the deal will go forward," Friedman said.

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