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Legal Update
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The IRS and Treasury Issue New Anti-Inversion Notice

On November 19, 2015, the US Treasury Department ("Treasury") and Internal Revenue Service ("IRS") released Notice 2015-79 ("Notice"), describing regulations the government intends to issue to further curb inversion transactions. Treasury and the IRS released this Notice even though they have yet to issue regulations implementing Notice 2014-52, the prior anti-inversion guidance released in September 2014.

The latest Notice introduces three types of rules: (1) rules to prevent taxpayers from avoiding the application of Internal Revenue Code ("Code") section 7874 to certain acquisition transactions (described below under "*Rules to Prevent Avoidance of Code Section 7874*"), (2) rules seeking to reduce or neutralize tax benefits perceived to be available through post-inversion transactions (described below under "*Rules to Address Post-Inversion Transactions*"), and (3) changes to clarify or provide relief under certain rules contained in Notice 2014-52 (described below under "*Changes to Notice 2014-52*").

Notably, the Notice does not include "earnings stripping" rules to address reduction of the US corporate tax base through interest expense deductions, although Treasury has announced that specific guidance in that area is expected in the coming months.

Background

Code section 7874 applies when, pursuant to a plan or a series of related transactions:

i. a foreign[1] corporation acquires (directly or indirectly) substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership);

ii. at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by the former shareholders of the domestic corporation (or by the former partners of the domestic partnership) *by reason of* holding stock in such domestic corporation (or holding an interest in such domestic partnership) ("Ownership Percentage"); and

iii. the expanded affiliated group which includes the foreign acquiring corporation does not have "substantial business activities" in the foreign country in which the entity is organized, when compared to the total business activities of the group ("Substantial Business Activities Test").

If these three conditions are met, the following adverse tax consequences result: (a) if the Ownership Percentage is at least 60 percent, but less than 80 percent, then the domestic acquired entity and its US related persons are limited in their ability to use certain tax attributes and, pursuant to Notice 2014-52 and the Notice, are subject to other adverse tax consequences with respect to certain post-inversion transactions, and (b) more drastically, if the Ownership Percentage is 80 percent or more, the foreign acquiring corporation is treated as a domestic corporation for all US income tax purposes (thereby likely eliminating the US tax benefits perceived to be associated with such a transaction).

Rules to Prevent Avoidance of Code Section 7874

THE SUBSTANTIAL BUSINESS ACTIVITIES TEST AND THE TAX RESIDENCY OF THE FOREIGN ACQUIRING CORPORATION

Treasury and the IRS are concerned that certain taxpayers may intend to escape Code section 7874 under the Substantial Business Activities Test even when the foreign acquiring corporation is not subject to tax as a resident in its country of organization. This could occur, for example, if the relevant foreign country determines tax residency based on the place of management and control rather than the place of formation, or if the foreign acquiring corporation is a reverse hybrid entity (i.e., taxed as a corporation for US tax purposes, but fiscally transparent under the tax laws of its country of organization). Treasury and the IRS believe this result is contrary to the policy underlying the Substantial Business Activities Test.

To address this concern, the Notice provides that the expanded affiliated group shall not be considered to have substantial business activities in the foreign acquiring corporation's country of organization unless the foreign acquiring corporation is subject to tax as a resident in that country.

Although this change further tightens the Substantial Business Activities Test, it will likely have limited impact in practice given that only in exceptional circumstances is a taxpayer able to rely on this test to avoid the application of Code section 7874 (the test imposes an exacting threshold, requiring that 25 percent of the expanded affiliated group's employees, assets *and* income be located or derived in the foreign acquiring corporation's country of formation).

THIRD-COUNTRY TRANSACTIONS

The Notice also takes issue with certain combinations of a domestic entity with an existing foreign corporation ("foreign target") when there is a foreign parent for the combined group that is tax resident in a different country than the foreign target. In such transactions (i) the stock or assets of the foreign target are acquired by the new third-country parent with the former shareholders of the foreign target receiving more than 20 percent of the stock of the parent, and (ii) the stock or assets of the domestic entity are acquired by the new third-country parent, with the former shareholders of the domestic entity receiving less than 80 percent of the stock of the parent.

Treasury and the IRS believe that the use of a third-country parent is generally driven by tax considerations, including the facilitation of US tax avoidance (e.g., to take advantage of a favorable tax treaty or favorable corporate tax regime that would not be available in the jurisdiction of the foreign target).

As such, the Notice provides that the stock of the foreign parent (the "foreign acquiring corporation" for Code section 7874 purposes) issued to the foreign target's former shareholders will be disregarded when the following requirements are met:

1. in a transaction related to the acquisition, the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by the foreign target;
2. the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the acquisition described in above exceeds 60 percent of the gross value of all property held pre-inversion by the foreign acquiring corporation (excluding certain passive assets and property acquired for purposes of avoiding the application of Code section 7874);

3. the tax residence of the foreign acquiring corporation is not the same as that of the foreign target (as determined prior to any transaction related to the acquisition described in (1) above, including a change in the place of management and control of the foreign target); and
4. the Ownership Percentage would otherwise be at least 60 percent but less than 80 percent.

If these four requirements are satisfied, the stock of the foreign acquiring corporation held by the former shareholders of the foreign target will be disregarded, excluding such stock from both the numerator and the denominator of the ownership fraction. Consequently, the Ownership Percentage would be 100 percent and the foreign parent of the combined group would be treated as a domestic corporation for US tax purposes.

It is worth noting that, in light of requirement (4) above, this new rule in no way affects those transactions in which the former shareholders of the domestic entity own less than 60 percent of the foreign acquiring corporation. For those transactions in which former shareholders of the domestic entity own between 60 percent and 80 percent of the foreign acquiring corporation, the Notice serves to prevent insertion of a third-country parent in a transaction related to the acquisition.

ANTI-STUFFING RULE

Treasury and the IRS have repeatedly voiced their concern that taxpayers may intend to "stuff" the foreign acquiring corporation in anticipation of an inversion transaction so as to reduce the Ownership Percentage and avoid the application of Code section 7874. To this effect, existing Treasury regulations disregard stock of the foreign acquiring corporation issued in exchange for "nonqualified property" in a transfer related to the acquisition. According to the regulations, nonqualified property means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations, or (iv) any other property acquired with a principal purpose of avoiding Code section 7874.

The Notice explains that some taxpayers may be narrowly interpreting the scope of item (iv) of the definition of nonqualified property. Specifically, some taxpayers may be taking the position that item (iv) only refers to property that allows for the indirect transfer of one or more of the specific items of nonqualified property described in (i) through (iii) above (e.g., stock of a corporation obtained in exchange for the contribution of marketable securities).

As a result, the Notice clarifies that avoidance property means *any* property acquired with a principal purpose of avoiding Code section 7874, regardless of whether it involves an indirect transfer of otherwise specified nonqualified property. In this respect, the Notice includes an example in which stock issued by the foreign acquiring corporation in exchange for the contribution of business assets is disregarded because the transfer is found to have the principal purpose of avoiding Code section 7874.

Rules to Address Post-Inversion Transactions

EXPANSION OF THE DEFINITION OF "INVERSION GAIN"

If a domestic entity is acquired in an inversion transaction in which the Ownership Percentage is at least 60 percent but less than 80 percent, Code section 7874 provides that the domestic target and its US related persons ("domestic expatriated entities") are limited in their ability to use certain tax attributes (e.g., net operating losses and foreign tax credits) to offset "inversion gain."

Under Code section 7874, "inversion gain" is generally defined as income or gain recognized by reason of (i) a transfer or license of property by a domestic expatriated entity as part of the inversion transaction, or (ii) a transfer or license of property (other than inventory) by a domestic expatriated entity to certain foreign related persons during the ten years following the inversion transaction ("applicable period").

This rule is generally intended to ensure that an appropriate "toll charge" is paid on "out-from-under" post-acquisition integration transactions and other transactions that accompany or follow an inversion and are perceived to remove income from foreign operations from the US tax net. Treasury and the IRS believe that a similar policy concern could exist when stock or property is not transferred directly by a domestic expatriated entity, but rather by a controlled foreign corporation ("CFC") owned by such a domestic expatriated entity.

To address this concern, the Notice provides that "inversion gain" shall also include income or gain recognized by a domestic expatriated entity from an indirect transfer or license of property made as part of the inversion transaction or to certain related foreign persons during the applicable period. For example, the domestic expatriated entity will be limited in its ability to use its tax attributes to offset Subpart F income recognized as a result of a CFC's sale of stock of a lower-tier CFC, or a CFC's license of intellectual property, to a related foreign person.

GAIN RECOGNITION IN CERTAIN CFC DILUTION TRANSACTIONS

Following an inversion transaction, taxpayers may seek to integrate CFCs with non-CFC foreign subsidiaries of the new foreign parent in order to dilute the US shareholder's ownership in the CFC, even to the point of "de-CFCing" the relevant foreign corporation.

Notice 2014-52 already addressed the concern of Treasury and the IRS with respect to CFC dilution transactions. That notice provided that if stock of a CFC of a domestic expatriated entity was transferred in a non-recognition exchange to a related foreign corporation during the applicable period, the exchanging US shareholder would generally be required to include as income an amount equal to the proportionate share of the CFC's deferred earnings. Departing from the regulations, Notice 2014-52 required this income pickup regardless of whether the foreign corporation remained a CFC after the exchange or whether the US shareholder retained a 10 percent interest in the CFC.

Treasury and the IRS are now concerned that, even with the income inclusion of deferred earnings under Notice 2014-52, the US shareholder may still avoid US tax on the built-in gain in the property held by the CFC of the expatriated entity (e.g., with respect to self-developed intangibles of the CFC that have yet to generate earnings). As a result, the exchanging US shareholder will now generally be required to recognize all of the gain in the exchanged CFC stock, without regard to the amount of the CFC's deferred earnings.

Changes to Notice 2014-52

RELIEF FOR INSURANCE COMPANIES UNDER THE CASH BOX RULE

Notice 2014-52 provided that, if the majority of the assets of the foreign acquiring corporation group consisted of passive assets ("foreign group nonqualified property"), stock of the foreign acquiring corporation attributable to such foreign group nonqualified property would be disregarded when determining the Ownership Percentage (thus increasing the Ownership Percentage and making it more difficult to avoid Code section 7874). This rule was intended to prevent US taxpayers' attempts to escape Code section 7874 by seeking "old and cold cash boxes" as foreign merger partners that were large enough to avoid surpassing the 80 percent (or 60 percent) Ownership Percentage.

Notice 2014-52 provided that foreign group nonqualified property does not include assets that give rise to income eligible for the banking exception under the passive foreign investment company ("PFIC") rules or the active financing, banking or insurance exceptions to Subpart F income. Surprisingly, however, Notice 2014-52 did not exclude from the definition of foreign group nonqualified property assets that give rise to income that qualifies under the PFIC insurance exception.

Insurance companies requested that this oversight be corrected given that certain companies may not meet the Subpart F insurance exception but still satisfy the less restrictive PFIC insurance exception. In response to these comments, the Notice now provides that property that gives rise to income described in the PFIC insurance exception will be excluded from the definition of foreign group nonqualified property. The Notice also highlights that separate guidance is expected under the PFIC provisions to prevent companies that do not conduct a *bona fide* active insurance business, as well as overcapitalized insurance companies, from inappropriately applying the PFIC insurance exception.

DE MINIMIS RELIEF UNDER THE SKINNY-DOWN DISTRIBUTION RULE

Treasury and the IRS previously stated their concern that taxpayers may be seeking to reduce the Ownership Percentage by having the domestic target make extraordinary distributions, thus reducing its size in anticipation of the inversion transaction. To address this perceived abuse, Notice 2014-52 provided that all "non-ordinary course distributions" made by the domestic target during the 36-month period ending on the acquisition date would be disregarded for Code section 7874 purposes (the "skinny-down distribution" rule).

Practitioners found that, as drafted in Notice 2014-52, the skinny-down distribution rule could technically apply even when the former shareholders of the domestic target received little or no equity in the foreign acquiring corporation (in an extreme case, this could have resulted in the anomalous result of Code section 7874 applying to an all-cash acquisition of a US company).

The Notice addresses this issue by carving out a *de minimis* exception to the skinny-down distribution rule. In this respect, "non-ordinary course distributions" will not be disregarded under the skinny-down distribution rule if (i) the Ownership Percentage is less than 5 percent (determined taking into account certain stock that would otherwise be disregarded), and (ii) after the inversion and all transactions related to the inversion are completed, the former shareholders of the domestic target own —in the aggregate— less than 5 percent of the stock of any member of the foreign acquiring corporation's expanded affiliated group. The Notice clarifies, however, that pre-inversion distributions may still be disregarded to the extent they are part of a plan a principal purpose of which is to avoid Code section 7874.

CLARIFICATION TO THE "SMALL DILUTION EXCEPTION"

Notice 2014-52 provided that, during the applicable period, issuances (or transfers) of stock of a CFC of a domestic expatriated entity to a foreign affiliate that is not itself controlled by a domestic expatriated entity (a "specified transaction") will generally be recharacterized as though (i) the property transferred to acquire the stock was transferred by the uncontrolled foreign affiliate to the domestic expatriated entity in exchange for an instrument deemed to have been issued by such domestic expatriated entity, and (ii) the domestic expatriated entity then contributed the property to the CFC in exchange for stock. This anti-dilution rule effectively prevents the "de-CFCing" of expatriated foreign subsidiaries.

Notice 2014-52 provided that the anti-dilution rule does not apply if (i) the expatriated foreign subsidiary remains a CFC after the specified transaction and related transactions, and (ii) "the amount of stock (by value)" owned in the CFC by the domestic expatriated entity does not decrease by more than 10 percent as a result of the specified transaction and related transactions (the "small dilution exception").

The Notice amends item (ii) of the small dilution exception by substituting "the percentage of stock (by value)" for "the amount of stock (by value)." Thus, if a CFC wholly-owned by a domestic expatriated entity is worth $100 prior to a specified transaction in which an uncontrolled foreign affiliate contributes $100 to the CFC, the small dilution exception will not apply because the interest of the domestic expatriated entity in the CFC decreased by 50 percent. This is so even though the CFC interest held by the domestic expatriated entity is likely still worth $100, as it was prior to the specified transaction.

EFFECTIVE DATES AND FURTHER GUIDANCE

The forthcoming regulations described in the Notice will generally apply to transactions completed on or after November 19, 2015 (no grandfathering exception is contemplated for transactions completed pursuant to a binding commitment existing prior to that date).

The expansion of the definition of inversion gain will apply to transfers or licenses of property occurring on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014 (the date of Notice 2014-52). Similarly, the rule requiring gain recognition upon certain CFC dilution transactions, as well as the clarification to the small dilution exception, will apply to exchanges occurring on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014.

As for the taxpayer-favorable amendments to the cash box and skinny-down distribution rules of Notice 2014-52, these are generally applicable to transactions completed on or after November 19, 2015, but taxpayers may elect to apply them to transactions closed before then.

Finally, the Notice reiterates that Treasury and the IRS expect to issue additional guidance to further limit inversion transactions including, as mentioned above, rules addressing earnings stripping.

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Endnote

[1] Throughout this document, "foreign" means "non-US" and "domestic" means "US".