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CROSS-BORDER M&A:

NOTICE 2014–52

J. Brian Davis

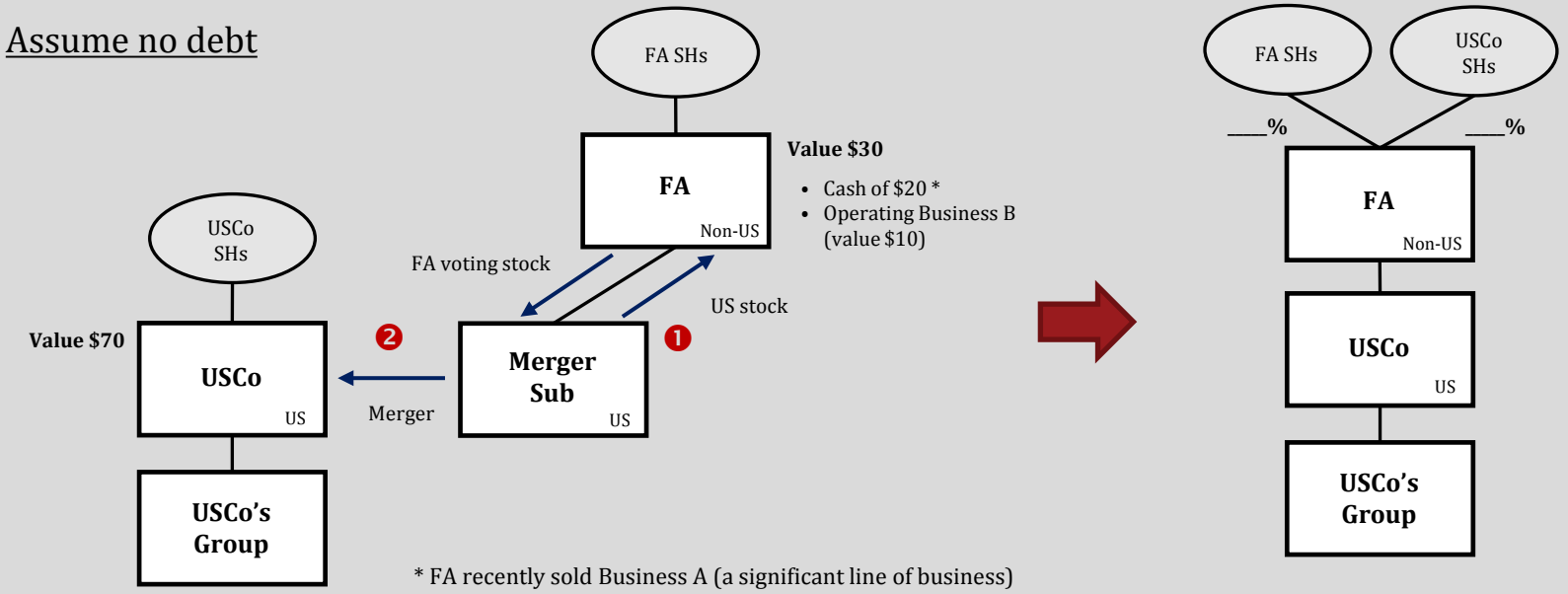
Penn State Law – Center for the Study of Mergers & Acquisitions
The Administrative Response to Inversions
8 October 2014

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 solely to "inverters" (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 on/after September 22, 2014.
- **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)**

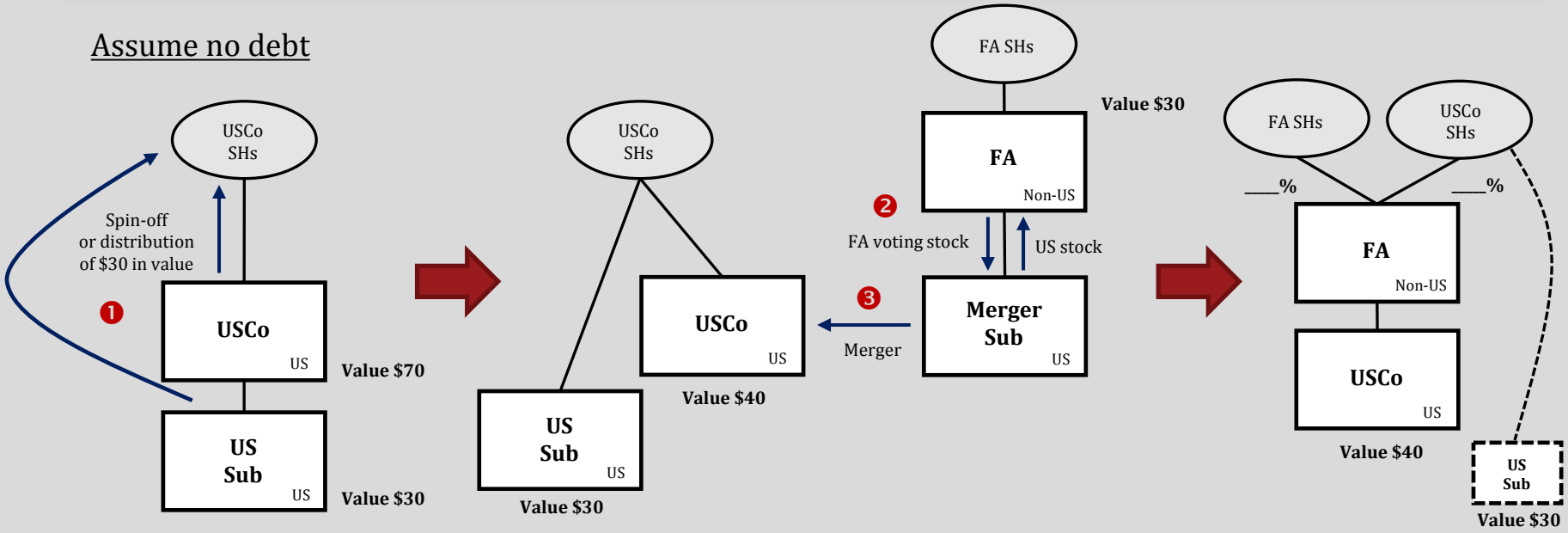
Anti-Cash Box Rules



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

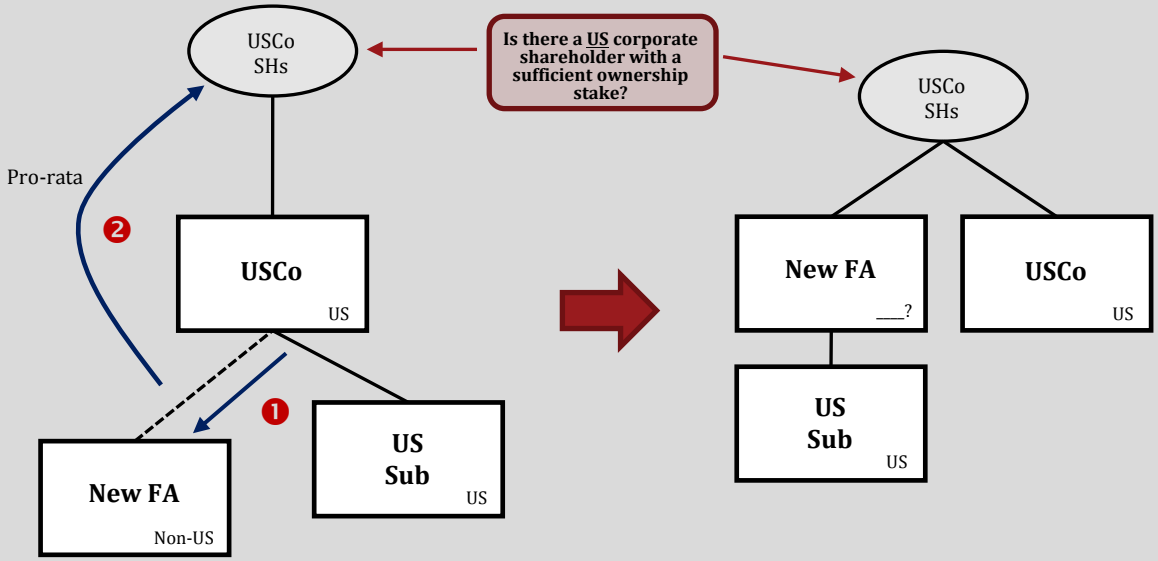
Anti-Slimming Rules



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

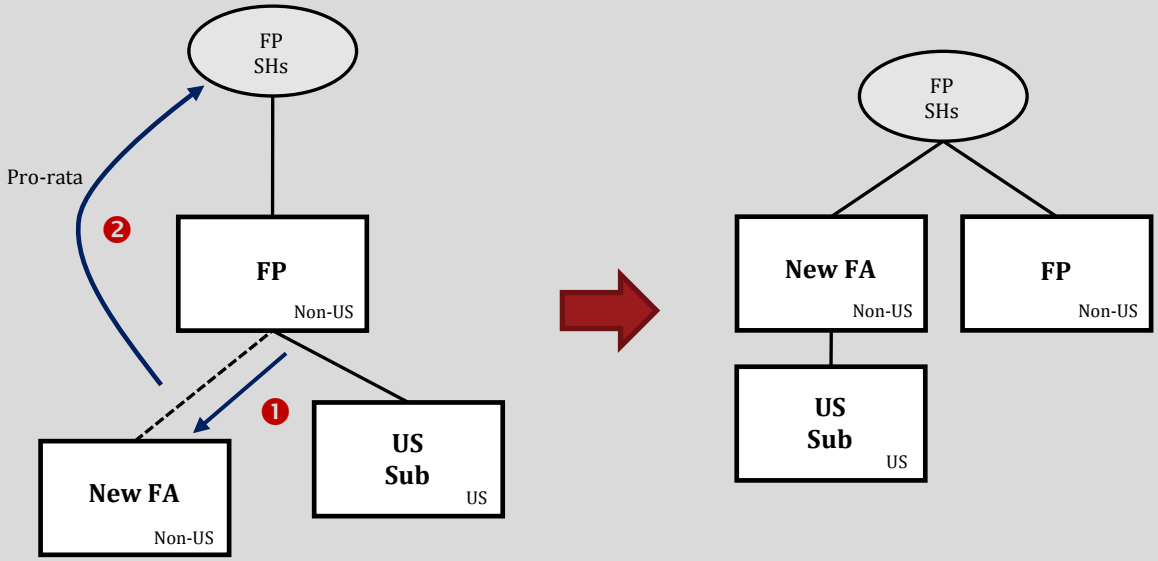
"Spinversion" Rules (US-Parented)



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)



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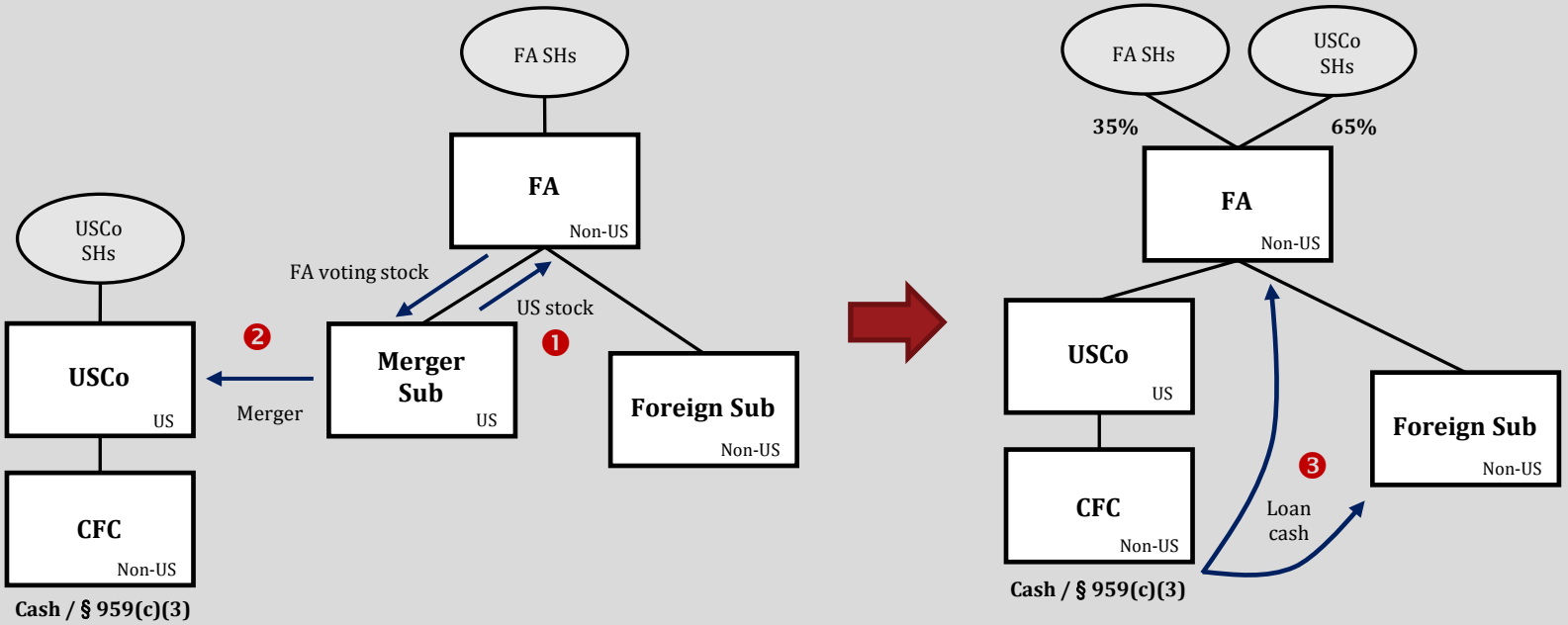
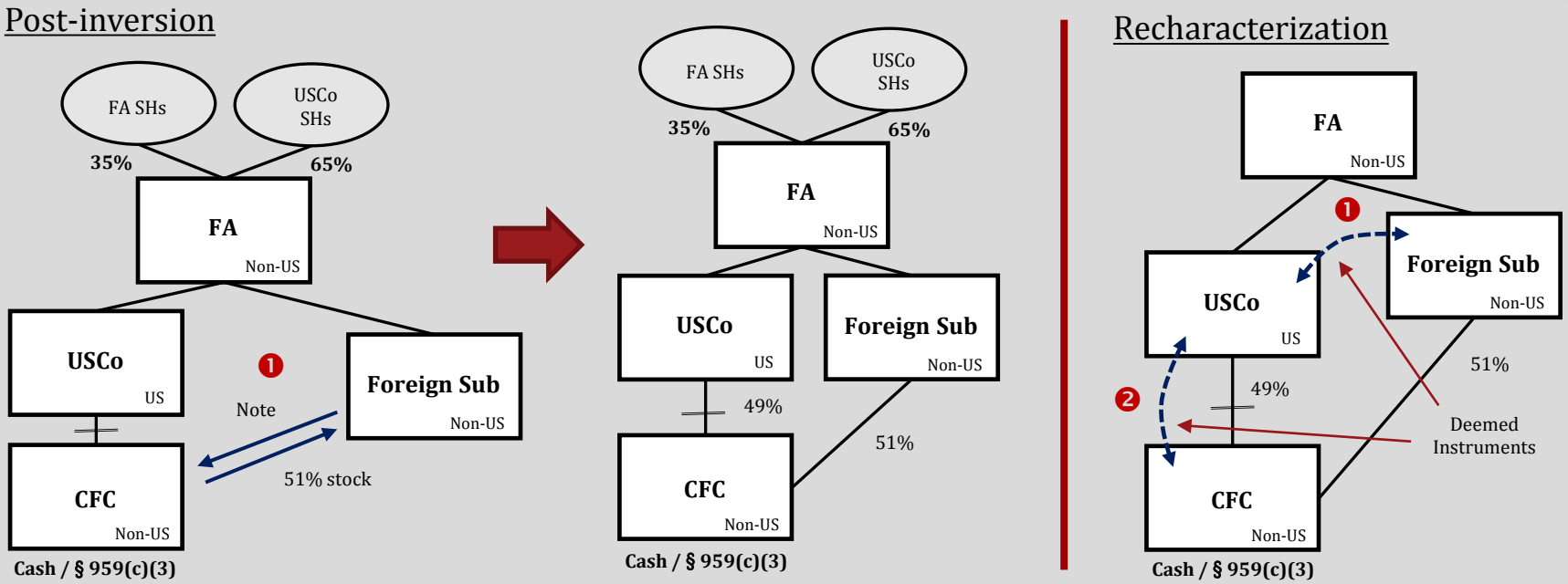
The New "US Property" Rules



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

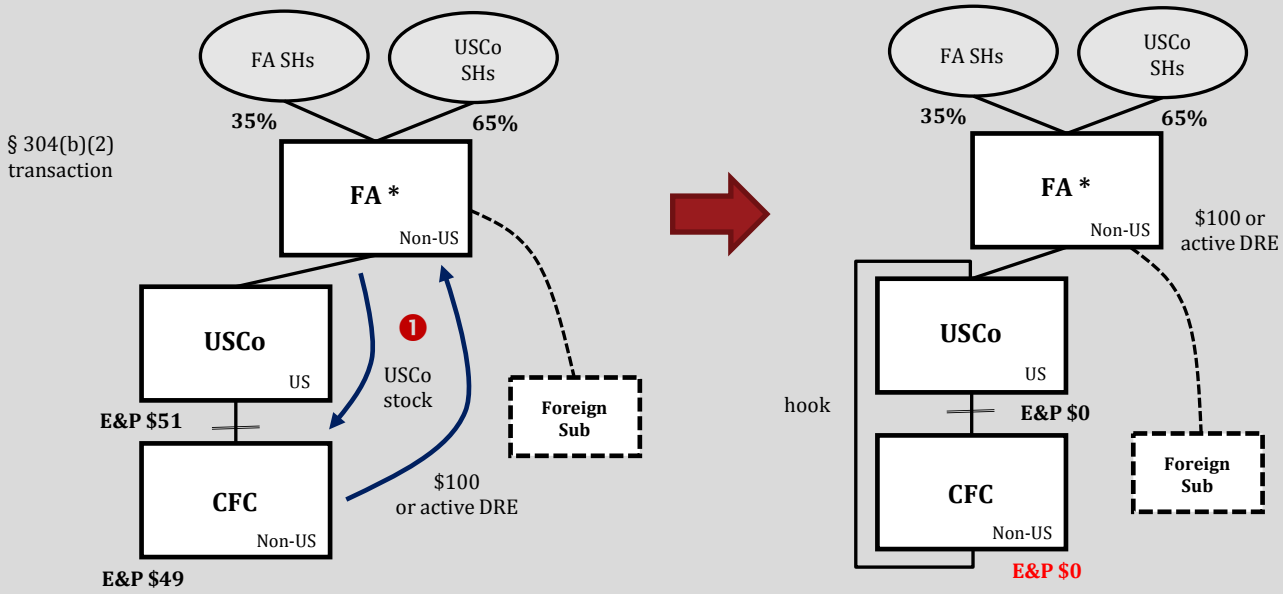


Notice § 3.02 – <u>De-controlling / dilution</u>

- *<u>Relevant authorities</u>* – § 7701(l), § 367(b), § 964(e), § 954(c)(6)
- *<u>Background</u>* – § 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
- *<u>Notice rules</u>* – 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 <u>directly</u> 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 recharcterization 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

Post-inversion



* FA is resident of treaty country with > 0% dividend treaty withholding rate (*e.g.*, Ireland)

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 (at least 60%) 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 tax avoidance guidance applies only to inverted groups, such guidance will apply to groups that completed inversion transactions on or after September 22, 2014***
>
> **– Notice 2014-52 § 5**

Thank you…

J. Brian Davis

BRIAN DAVIS is a partner in the Washington, D.C. office of Ivins, Phillips & Barker. He has practiced in all areas of U.S. federal income taxation, with considerable experience assisting public and private businesses with U.S. and global tax planning matters. He regularly serves as a trusted tax adviser to Fortune 200 companies and high net worth individuals, and has also worked in industry as Director of International Tax for a publicly-traded global media conglomerate. Brian is regularly engaged by corporate and tax executives seeking proficient and pragmatic advice regarding cross-border transactional design and implementation, as well as general troubleshooting of domestic and international tax matters.

Brian regularly speaks at events sponsored by TEI (where he previously served as Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

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