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M&A Tax, International Tax & Tax Accounting Update

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HIGHLIGHTS

IRS Issues Another Notice to Curb Inversions

On November 19, 2015, IRS issued Notice 2015-79 (the "Notice"), which announces IRS and Treasury's intent to issue regulations under section 7874 to reduce the tax benefits for U.S. corporations to engage in inversion transactions. The Notice includes new rules designed to limit inversions and reduce the tax benefits of certain post-inversion transactions, as well as makes corrective changes to Notice 2014-52 (issued on September 22, 2014). The Notice generally applies to inversions completed after November 18, 2015.

Section 7874 targets transactions in which a foreign acquiring corporation acquires a domestic corporation if, after the acquisition, the percentage of stock of the foreign acquiring corporation held by former shareholders of the domestic corporation (the "ownership percentage") is at least 60%, unless the expanded affiliated group that includes the foreign acquiring corporation has substantial business activities in the foreign country in which the foreign acquiring corporation was created or organized (the "EAG Test"). The tax treatment of an acquisition that fails the EAG Test depends on the ownership percentage. If the ownership percentage is 80% or more, the foreign acquiring corporation is treated as a domestic corporation for all tax purposes. For ownership percentages below 80%, adverse tax consequences are limited to entities that were U.S. persons before the inversion.

Notice 2015-79 adds the following new rules:

Anti-Stuffing Rule. The Notice confirms that decreasing the ownership percentage by contributing assets to the foreign acquiring corporation will be disregarded if there was a principal purpose of avoiding section 7874. The Notice clarifies that this anti-stuffing rule will apply to any assets (including active business assets).

Third-Country Inversions. The Notice effectively prevents companies from satisfying the requirements of section 7874 in transactions in which a

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domestic entity combines with an existing foreign target corporation to establish a new foreign acquiring corporation with a tax residence in a country different from that of the foreign target corporation. In such cases, stock in the foreign target corporation that would otherwise be included in determining the ownership percentage will be disregarded.

Tax Residency Limitations. The Notice precludes a foreign acquiring corporation that is a tax resident of one country from becoming a tax resident of a second country while retaining the first country's corporate law and other benefits. Specifically, the Notice prohibits expatriating corporations from relying on the substantial business activities exception where the foreign acquiring corporation is not a tax resident of the country in which it is incorporated. This situation can arise if the country of incorporation determines tax residency based on the place of management and control or if the foreign acquiring corporation is a reverse hybrid (*i.e.*, it is treated as a corporation for U.S. income tax purposes, but is considered a transparent entity for local tax purposes).

Expansion of Scope of "Inversion Gain." Under current law, an inverted company must pay tax on the gain recognized when it transfers stock in its CFCs or other property to the foreign acquiring corporation, without the benefit of tax attributes (such as NOL carryovers) to offset the gain. The Notice expands the scope of this rule to cover certain indirect transfers of stock or other property, including transfers undertaken by foreign subsidiaries of the former U.S. parent and indirect transfers of stock or property or licenses of property if the transfer or license is made either as part of the inversion transaction or is to a foreign related person. This provision applies to transfers occurring after November 18, 2015 with respect to inversions completed after September 21, 2014.

Built-In Gain on Stock of a CFC. The Notice provides that, subject to applicable nonrecognition provisions, the expatriated entity will be required to recognize the full amount of net unrealized built-in gain on CFC stock exchanged in certain restructuring transactions. Under previous guidance, gain recognition was limited to the amount of undistributed E&P that had not yet been included in income by the expatriated entity. This provision applies to exchanges occurring after November 18, 2015 with respect to inversions completed after September 21, 2014

The Notice is also important for what it does not do. The Notice did not address earnings stripping transactions in the context of corporate expatriations. However, taxpayers should not infer from this that Treasury believes it lacks regulatory authority to act.

Pfizer-Allergan Merger

On November 23, 2015 (shortly after Notice 2015-79 was issued), Pfizer Inc. and Allergan plc, an Irish company, announced that their respective boards had unanimously approved a merger of Pfizer into Allergan. Under the terms of the merger, Pfizer and Allergan will be combined under Allergan plc, maintaining Allergan's Irish legal domicile with Pfizer shareholders receiving 56% of the stock in the new foreign parent. While it appears that the merger will fall below the 60% ownership percentage threshold under section 7874, the announcement precipitated calls for additional measures to curb inversions. Treasury officials have emphasized that Congressional action is needed to effectively curb inversions. Absent such action, U.S. corporations will continue to consider expatriating.

Darden Restaurants Completes Opco-Propco Spinoff after Receiving a PLR

On November 9, 2015, Darden Restaurants Inc. completed a tax-free spinoff of 430 properties, primarily Olive Garden restaurants. The properties were contributed to Four Corners Property Trust, Inc. ("Four Corners"), which was spun off to existing Darden shareholders and will be an independent, public company electing to be taxed as a REIT. Four Corners will lease the properties back to Darden under long-term leases. The transfers to Four Corners included six Longhorn Steakhouse restaurants, which will be operated by a taxable REIT subsidiary of Four Corners. These operations ostensibly constitute Four Corners' "active trade or business." Darden announced that it had received a private letter ruling ("PLR") from IRS, covering certain tax issues, in connection with the spinoff.

Under Rev. Proc. 2015-43, IRS will not ordinarily rule on spinoffs followed by REIT elections or on spinoffs involving an active trade or business that constitutes less than 5% of the distributing corporation's assets. While the Darden transaction appears to fall under both categories, Darden submitted its PLR request ruling before IRS issued Rev. Proc. 2015-43. Because Darden's PLR will not be released, in redacted form, to the public for several months, it is not clear whether the PLR directly addresses these no-rule issues.

Darden's transaction comes as both McDonald's and Macy's have recently announced that they would not pursue a spinoff of real estate assets. In addition, Yahoo! Inc. has been pursuing a spinoff of its holdings in Alibaba which involves a small active trade or business and, like Darden, submitted a ruling request before the recent no-rule policies. Yahoo! recently announced that it would not receive a ruling from IRS, but would proceed with the spinoff based solely on an opinion of counsel.

IRS Issues New Revenue Procedure for the Retail Industry

In 2013, Treasury issued new final regulations under section 263(a) of the Code that distinguish between expenditures that taxpayers must capitalize as an improvement to property and deductible repair expenses. IRS indicated that it would undertake industry resolution projects to assist in the application of these new repair regulations to particular industries, one of which was the retail industry.

IRS recently issued Rev. Proc. 2015-56 that provides guidance for taxpayers in the retail industry with respect to the application of the new repair regulations. In lieu of applying all of the detailed rules in those regulations for distinguishing between capital improvements and deductible repairs, Rev. Proc. 2015-56 gives retail-industry taxpayers the option to adopt a safe-harbor accounting method for distinguishing between such expenditures. Under this short-cut approach, taxpayers may treat 75% of their total annual expenditures to remodel or refresh retail stores as a deductible repair expense and may treat 25% of such expenditures as capital improvements that are eligible for depreciation. If a taxpayer elects to use this short-cut approach, the taxpayer must place the capitalized portion of the expenditures in one or more "general asset accounts" and may not claim any losses for partial dispositions from such accounts.

IP&B believes these short-cut procedures are sufficiently attractive that most, if not all, retailers should adopt these procedures.

Court Rejects Argument that Hiring of Outside Law Firm in High-Stakes Transfer Pricing Audit Was Improper

In late November, a Federal district court enforced IRS summonses in an audit of Microsoft's transfer pricing that reportedly could lead to income adjustments as high as $30 billion. Citing an IRS employee's testimony that the summonses were intended to help the IRS "get to the right number" and referencing the "heavy burden" on taxpayers seeking to defeat a summons, the court rejected Microsoft's arguments that IRS had acted in bad faith and with improper purpose in issuing the summonses.

Microsoft's chief complaints were that IRS had hired law firm Quinn Emanuel after deceiving the company into extending the statute of limitations, and intended to allow Quinn Emanuel attorneys to question Microsoft witnesses, assume IRS audit functions, and help IRS prepare for trial (rather than conduct an audit). The court, however, found that IRS was not required to disclose the firm's potential involvement when it obtained the extension, the Code does not prohibit contractors from questioning witnesses, and Microsoft's remaining assertions were speculative. While "troubled" by Quinn Emanuel's involvement in the audit, the court suggested that any remedy would be legislative.

The Microsoft audit is not typical in size or scope, and this is not a weapon IRS would be expected to use in routine audits. However, in audits involving high-priority compliance issues and potentially large-dollar adjustments, taxpayers should be aware of the possibility that IRS may enlist the assistance of outside attorneys.

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Litigation Update

Taxpayers' petition with the D.C. Circuit Court in *Florida Bankers Ass'n v. Treasury* (see our September update) for a rehearing *en banc* was rejected. The taxpayers are expected to file a petition for a writ of certiorari to the U.S. Supreme Court.