

SEPTEMBER 24, 2014

### Inversion Guidance Hits Pending Deals, Not Previous Inverters

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New Treasury guidance aimed at making inversions more difficult to accomplish as well as substantially reducing the tax benefit from inverting includes several significant changes to existing rules, but only punishes yet-to-be completed inversions, a practitioner said September 23.


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New Treasury guidance aimed at making inversions more difficult to accomplish as well as substantially reducing the tax benefit from inverting includes several significant changes to existing rules, but only punishes yet-to-be completed inversions, a practitioner said September 23.

"The transactions that they are targeting are a significant part of post-inversion planning," Layla J. Aksakal of Miller and Chevalier said.

Aksakal said the prospective nature of the "wide-ranging package" that applies the new rules to inversion transactions occurring on or after September 22 was significant. She noted that the rules were prospective in both defining an inversion under the expanded scope of section 7874 and with regard to provisions addressing post-inversion planning.

Treasury "could have made it so that going forward companies are subject to this new section 956 rule, for example, but they didn't just do that," Aksakal said. Instead, companies that completed an inversion before September 22 are not subject to the section 956 rule, she said, adding, "To the extent they rely on this type of planning, pending deals are hammered."

Michael Mollerus of Davis Polk & Wardwell LLP was likewise surprised that the guidance was not retroactive. Treasury Secretary Jacob Lew "had been very vocal that to him, retroactivity was important," Mollerus said, "so maybe he thinks he achieved that by applying this to pending deals." On September 22, a senior Treasury official said that not making the notice retroactive was in accordance with the normal approach to administrative guidance. (Prior coverage )

Notice 2014-52, 2014-42 IRB 1 , released September 22, limits some tax benefits to be gained through inverting by preventing the avoidance of section 956 through post-inversion acquisitions by controlled foreign corporations of obligations of (or equity investments in) the new foreign parent corporation or some foreign affiliates. It prevents the avoidance of U.S. tax on pre-inversion earnings and profits of CFCs through post-inversion transactions that otherwise would terminate the CFC status of foreign subsidiaries and/or substantially dilute the U.S. shareholders' interest in those earnings and profits, and it limits the ability to remove untaxed foreign E&P of CFCs through related-party stock sales subject to section 304.

Mollerus described the notice as an "ambitious" attack by Treasury on the economics of inversions that will potentially deter some, but not all, inversion transactions.

Neil Barr of Davis Polk said the notice will affect companies' financial analysis of inversion transactions. "One of the core synergies of the inversion transaction has been made materially more difficult, if not gone away," he said.

Carol P. Tello of Sutherland Asbill & Brennan LLP agreed that the notice may deter some transactions, but said others will continue to go forward because the value of the transaction far exceeds the U.S. tax cost and will benefit a company in the long run. "For some transactions, the changes to the stock ownership rules of section 7874 may affect whether the transaction goes forward. Exceeding the 80 percent threshold is not an option, so those changes may have an impact on some planning," she said.

The notice explains that coming regulations will address transactions that are structured to avoid the purposes of sections 7874 and 367 by disregarding some stock of a foreign acquiring corporation that holds a significant amount of passive assets and thereby disregarding some non-ordinary course distributions. The regs will provide guidance on the treatment of specific transfers of stock of a foreign acquiring corporation (through a spinoff or otherwise) that occur after an acquisition.

Joseph Calianno of Grant Thornton LLP said that the IRS and Treasury took a "fairly comprehensive" two-pronged approach in the notice by issuing guidance to make it more likely for section 7874 to apply on the front end, and guidance regarding post-inversion transactions and structures on the back end.

"All in all, the notice appears to be a careful approach to exercising existing regulatory authority," Tello said. "Although regulations are described under a number of code sections, the Treasury is provided broad regulatory authority under those code sections."

J. Brian Davis and Robert H. Wellen, both of Ivins, Phillips & Barker, said Treasury took a thoughtful and targeted approach. "They had a tough job," said Wellen. "There are a lot of threshold issues to think about, and they did a terrific job."




Davis said the provisions concerning the hopscotch rule could make some inversion transactions more expensive for companies to execute. "It would suggest they'd need to have alternative financing available," he said.

### **Strengthening Section 7874**

In seeking to strengthen section 7874 by disregarding some stock attributable to passive assets,

the notice states that Treasury and the IRS "are aware that taxpayers may be engaging in transactions with a foreign corporation that has substantial cash and other liquid assets in order to facilitate an inversion to avoid the application of section 7874." The notice states that Treasury and the IRS will therefore issue regs under section 7874(c)(6) that provide that if more than 50 percent of the gross value of all foreign group property constitutes foreign group nonqualified property, a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction for purposes of calculating whether a company is a surrogate foreign corporation.

If 60 percent of stock is held by former shareholders of the domestic corporation, some tax limitations continue to apply to the inverting company. According to the notice, foreign group nonqualified property is property that is described in reg. section 1.7874-4T(i)(7) other than property that gives rise to income described in section 1297(b)(2)(A) or section 954(h) or (i).

Aksakal said that Treasury views its authority under section 7874 as expansive and well-established. She said practitioners argued against its authority when it issued Notice 2009-78, 2009-40 IRB 452 , under section 7874, which resulted in temporary regs (T.D. 9654 ) this year. "There are still questions, but they may be water under the bridge at this point," she said. (Prior coverage )

The notice looks to disregard some distributions by domestic entities, given that an inverting company "may distribute property to its former shareholders . . . in order to reduce the ownership fraction by reducing the numerator." The notice also addresses transactions designed to avoid the application of section 367(a)(1) when a U.S. target company may distribute property to its shareholders in contemplation of an acquisition to satisfy the substantiality test.

Calianno said that the creation of an "irrebuttable presumption" that disregards non-ordinary course distributions made by a domestic entity during a three-year period ending on the acquisition date as part of a plan with a principal purpose to avoid section 7874 could apply even though such distributions were not in contemplation of an inversion. "They're creating a per se rule," Calianno said. "If it kicks in, it kicks in."

### **Addressing Post-Inversion Avoidance**

By taxing the investment by a CFC of its E&P in U.S. property, section 956 prevents a U.S. shareholder of a CFC from accessing the CFCs untaxed E&P in ways other than the payment of an actual taxable dividend. Section 956(e) allows for regs that would prevent the avoidance of provisions of section 956 through reorganizations, such as an inversion, the notice states. It also states that regs will be issued that provide that any obligation or stock of a foreign related person will be treated as U.S. property to the extent that such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period, within the meaning of section 7874(d) (1). That section defines applicable period as from the first date properties are acquired in an inversion until 10 years after the last date properties are acquired.

Aksakal said that while Treasury was careful to show its steps in claiming its authority to regulate under section 956(e), its analysis within the notice was not typical, given how narrowly it tailored its application.

"It's a little unusual to say, 'We're regulating under 956, but the rule only applies to inversion transactions,'" Aksakal said. "What's the policy basis for drawing the line at inversions?" She

added that usually, practitioners think of section 956(e) as applying to the reorganization of a CFC, not a transaction at the parent level, as is the case with an inversion.

In addressing transactions to decontrol CFCs, the notice invokes the authority of section 7701(l), which provides that to prevent tax avoidance, regs may be issued recharacterizing any multiple-party financing transaction as a transaction directly among two or more parties. The notice outlines a potential abuse:

After an inversion transaction, a foreign acquiring corporation could issue a note or transfer property to an expatriated foreign subsidiary in exchange for stock representing at least 50 percent of the voting power and value of the expatriated foreign subsidiary. The expatriated foreign subsidiary would cease to be a CFC, and the U.S. shareholders would no longer be subject to subpart F of the Code with respect to the expatriated foreign subsidiary.

The notice seeks to recharacterize a specified transaction, one in which stock in an expatriated foreign subsidiary is transferred to a specified related person, such as a non-CFC foreign related person, as an arrangement directly between the related party and a section 958(a) U.S. shareholder.

Aksakal said that Treasury's claim of regulatory power under section 7701(l) is "a creative use of authority."

"Everyone thinks of section 7701(l) as an anti-conduit rule. The notice goes out of its way to say, 'Yes, we know it's an anti-conduit rule, but it's not only an anti-conduit rule,'" Aksakal said. She added that the notice cites language in the legislative history that demonstrates the statute had a broader purpose.

Calianno also said that Treasury had taken "an expansive approach" in applying both section 956(e) and section 7701(l) to inversions.

"They read the reg authority very broadly to address . . . transactions that the IRS and Treasury view as inappropriate," Calianno said. The regs are recasting transactions to get a particular result, such as treating a foreign corporation that otherwise looks like it isn't a CFC as a CFC, he said, adding that the IRS had done "recasts in the past to achieve certain results," citing as an example the Killer B regs.

Patrick J. Smith of Ivins, Phillips & Barker said that the provision under section 7701(l) is the one that is the most vulnerable to challenge.

"The statutory provision authorizes regulations on 'multiple-party financing transactions,' but the rule in the notice applies to two-party transactions. This rule thus seems clearly inconsistent with the statutory provision and thus invalid under *Chevron* step one," Smith said. Under *Chevron*, courts look to the plain meaning of a statute and if the statute is clear and unambiguous, the agency must give effect to congressional intent.

The notice also states that the regs under section 367(b) will be amended to provide that an exchanging shareholder will be required to include as a deemed dividend the section 1248 amount attributable to the stock of an expatriated foreign subsidiary exchanged in a specified exchange, which is an exchange in which a shareholder of an expatriated foreign subsidiary exchanges stock in the expatriated foreign subsidiary for stock in another foreign corporation in

accordance with a transaction described in reg. section 1.367(b)-4(a).

According to Monte Jackel, Example 2 in the section of the notice on transactions that will be recharacterized and thereby create a deemed instrument may cause more confusion than it's worth.

Jackel said that under the current, pre-notice rules, there is a question about whether DT, a domestic corporation, could make the transfer of stock of a foreign corporation that is a CFC to FPRS, a foreign partnership, for tax purposes. The question arises because there is a rule in sections 958(a)(1)(B) and 958(a)(2) that treats partners as indirectly owning the stock owned by the entity, he said.

The example states that, after recharacterization, the foreign partnership is treated as having issued its capital and profits interest to the domestic corporation in exchange for a deemed instrument. Jackel questioned why the government would note that a deemed instrument has been created when the current rules may well indicate that nothing has actually been transferred to the foreign partnership. This is so, he said, because under sections 958(a)(1)(B) and (a)(2), DT will be treated as retaining either 40 percent of the stock or all of the stock if proportionate ownership is determined applying section 704(c) principles.

"Are they now creating an inference that there would be a transfer of the CFC stock to the foreign partnership?" Jackel asked. He said that the deemed instrument rule would not be necessary if there had not been a transfer to the partnership of the CFC stock by DT.

Jackel also said that it was odd that the notice, which is aimed at preventing abuse, failed to cite reg. section 1.701-2, which contains the partnership antiabuse rule. He said that it would seem to be relevant guidance to mention, adding, "If you're not going to use [the partnership antiabuse rule], then get rid of it."

Mollerus said Example 2 is consistent with the somewhat unusual approach Treasury is taking with decontrolled transactions. "Example 2 is a little interesting because a partnership is involved in the structure, but it's perfectly consistent with the underlying approach taken by the notice to create this deemed tracking instrument," he said.

### **Taxpayer-Favorable Rule**

Aksakal said that one small taxpayer-favorable rule for foreign-parented groups did come out of the notice, under the rule regarding subsequent transfers, or "spinversions." The notice addresses internal restructuring that may have otherwise caused taxpayers concern about inadvertent inversions, by providing an exception for foreign-parented groups.

Calianno said that the notice's provision that taxpayers may elect to apply the rule in section 2.03(b)(iii) of the notice (regarding subsequent transfers of stock of the foreign acquiring corporation when a domestic entity is a member of a foreign-parented group) to acquisitions completed before September 22, 2014, could be beneficial for some taxpayers. He cited to the base facts of Example 2 in section 2.03(b)(iv) of the notice to be issued under section 7874 regarding subsequent transfers of stock of the foreign acquiring corporation. That example involves an individual who owns all the stock in a foreign holding corporation (with no liabilities), which in turn owns all the stock in a domestic corporation, and the foreign corporation transfers all its stock in the domestic corporation to a newly formed foreign acquiring corporation in a section

368(a)(1)(F) reorganization.

"Before they came out with this guidance, there was a question whether that transaction would result in an inversion," Calianno said. "This rule here reaches the conclusion that it doesn't result in an inversion, on the base facts of Example 2."

Mollerus said the notice contains some helpful provisions that seem to address the concerns raised by the New York State Bar Association Tax Section that there are some transactions to which the section 7874 rules shouldn't apply. "Kudos to Treasury for including those provisions," he said.

### **No Earnings Stripping Provisions**

Calianno noted that the notice does not include any rules under section 163(j), relating to earnings stripping.

Barr said he wasn't surprised that Treasury didn't attempt to address earnings stripping by including measures to reclassify debt as equity. "The conventional wisdom among tax practitioners is that of all the potential lines of attack, earnings stripping would be the most challenging for Treasury," he said.

Bret Wells of the University of Houston Law Center was disappointed with the narrowness of the guidance, which he said tries to "kill the inversion messenger" without addressing the basic problem. The notice is silent about the fact that U.S. tax law creates a tax advantage to foreign-owned multinational enterprises regarding the amount of their U.S. tax liability payable on their U.S. business activities in comparison with the tax liability a U.S. MNE would incur on those same U.S. business activities, he said. As a consequence, the notice by itself would not stop inversions, he added.

"The IRS has left the main problem unaddressed in this notice. [By] focusing only on inverted companies, the IRS notice is not treating the problem as a larger inbound U.S. tax problem that exists for all foreign-owned MNEs, not just inverted companies," Wells said. "As long as a U.S. earning stripping advantage continues to exist for foreign-based MNEs with respect to their U.S. operations, U.S. MNEs will want to reinvent themselves (engage in inversions) so that they can equally attain these same U.S. earning stripping opportunities for their own U.S. business activities."

But administrative action against inverted companies' abilities to strip out U.S. earnings may still be coming. The notice states that Treasury and the IRS are expected to issue more guidance and that they are specifically considering guidance to address U.S. earnings stripping through intercompany debt. The notice requests comments on approaches that guidance should take. Previous budget proposals by the Obama administration have sought to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons by eliminating the debt-to-equity safe harbor and reducing the adjusted taxable income threshold for the limitation from 50 to 25 percent. Wells previously questioned why any amount of earnings stripping should be allowed. (Prior analysis.)

Also not included in the notice are any announcements concerning how treaties will be affected, Tello noted, although the notice states that Treasury is reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain tax treaty benefits that

reduce U.S. withholding taxes on U.S.-source income.

"It is not immediately clear how the U.S. could deny benefits bestowed by a treaty partner on income from the treaty partner, although potentially the saving clause could be applied or foreign tax credits could be denied for the withholding taxes," Tello said.

Wellen was struck by the statement in section 5 of the notice regarding the effective date of possible future guidance addressing earnings stripping:

Future guidance will apply prospectively; however, the Treasury Department and the IRS expect that, to the extent 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.

"It seems to be an unusual parsing of the effective date," Wellen said. "The idea that future guidance will be prospective is the norm. But then you have this limited class of antiavoidance guidance that Treasury says they expect will apply only to inverted groups on or after what's now a retroactive date. Once you read this, it's almost like you can't look at anything else.

"It's striking, and of course, we don't know what this future guidance will be, if there will be any, and whether they will in fact make it retroactive," Wellen continued. "But they're certainly signaling that they reserve the right to do that."

Smith said there may be a problem with some of the effective dates in the notice, adding that although section 7805(b) grants Treasury the authority to issue regulations that apply retroactively to the date of a notice indicating what the regulations will say, the inversion notice lacks details about those possible future regulations. "That strikes me as questionable," he said.

While section 385, which allows the secretary to prescribe regs related to the classification of debt and equity, was enacted before the current version of section 7805(b) and thus is not technically covered by that rule, a court would likely look to those provisions as helpful guidance on congressional intent on the retroactivity issue, Smith said.

Wellen said the wording will complicate advisers' opinion process. "It will make it more difficult when you've got a sword of Damocles hanging over your head, and you don't know what the content of that guidance might look like and whether Treasury will make it retroactive," he said.

Davis said there might have been a tactical decision behind the wording of the effective date of possible earnings stripping guidance. "It may provide an *in terrorem* impact by signaling that Treasury could issue regs on earnings stripping, but effectively they've tossed it back to Congress, suggesting that it's in their court now," he said. He added that it could be difficult for Treasury to draft rules on section 163(j) because Congress was precise in drafting the law and made it generous. "While there are several grants of authority in this area, I'm not sure the effort would've accomplished what Treasury wanted to accomplish. Similarly, they may have taken the view that, given the history of section 385, it was better not to write any regs at this point," Davis said.

## Coming Challenges

Barr said it would be difficult to speculate whether the notice will curb or end inversions. "Tax is not the only reason inversions occur," he said. "Even with this action, the administration didn't take away all potential tax planning opportunities. So when you overlay the fact that there are good business reasons outside of tax for many of these transactions, and you augment that with the fact that there remains some tax planning opportunities in the inversion space, it's probably the case that there's room for inversion transactions to continue as a viable structure."

*Jaime Arora and Amy S. Elliot contributed to this article.*

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## Tax Analysts Information

**Code Sections:** Section 304 -- Redemption through Related Firm  
Section 956 -- CFC Earnings Investment  
Section 7701(l) -- Conduit Financing Arrangements  
Section 7874 -- Expatriated Entities and Foreign Parents  
Section 367 -- Foreign Corporations  
Section 163(j) -- Earnings Stripping

**Jurisdiction:** United States

**Subject Areas:** Cross-border mergers and acquisitions  
Corporate taxation  
Controlled foreign corporations (CFCs)

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**Institutional Author:** Tax Analysts

**Tax Analysts Document Number:** Doc 2014-23212

**Tax Analysts Electronic Citation:** 2014 TNT 185-1