

April 28, 2014

Corporate Inversion Transactions

IRS Announces Intent to Issue Regulations Under Section 367 Directed at Certain Transactions

SUMMARY

On April 25, 2014, the IRS issued Notice 2014-32 (the “Notice”), stating that the IRS and Treasury Department will issue regulations (the “Regulations”), to be effective immediately, targeting certain transactions that the IRS believes to be contrary to the policy underlying Section 367 which imposes tax on shareholders of a US target that is acquired by a foreign acquirer (i.e., becomes “inverted”) where transferring US shareholders own more than 50% of the combined entity. The Notice is aimed at inversion transactions that were structured to avoid such shareholder-level gain recognition. As a result, inversion transactions in which the former US shareholders of the acquired US corporation end up with more than 50% of the foreign acquirer will likely be taxable transactions to the former shareholders of the US corporation (and an excise tax may also apply to certain previously deferred equity compensation payable to senior executives and directors).

In the Notice, the IRS describes a transaction (the “Transaction”) where (1) a foreign corporate parent (“FP”) forms a domestic subsidiary (“USS”) that generates a small amount of earnings and profits, (2) USS acquires stock of FP in exchange for a note, and (3) USS exchanges the acquired FP stock for all the stock of a domestic target corporation (“UST”) in a tax-free triangular reorganization which results in the former US holders of UST stock acquiring a majority of FP’s stock. The Notice states that the IRS has become aware that taxpayers have designed the Transaction in a way to take the position that (i) no gain is recognized by the former US holders of UST stock on the exchange of their UST stock for FP stock and (ii) only a small amount of US withholding tax is due on USS’s deemed distribution to FP. The Notice states that the IRS and Treasury disagree with the interpretations of existing regulations underlying such intended treatment and that the Regulations will provide several important modifications and additions to the existing regulations, as discussed below.

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The Notice provides that the Regulations will be effective for transactions completed on or after April 25, 2014, but generally carves out transactions that are completed pursuant to a binding agreement entered into prior to such date. The Notice states that no inference is intended regarding the treatment of the Transaction, and states that the IRS may challenge such transactions under current law.

BACKGROUND

In 2011, the IRS and Treasury Department finalized regulations under Section 367,¹ including certain regulations under Section 367(b) (the “1.367(b)-10 Regulations”) that apply to triangular reorganizations in which the parent corporation (“P”) and/or its subsidiary corporation (“S”) is foreign, S acquires stock of P in exchange for property, and S exchanges the acquired P stock for stock or property of a target corporation (“T”). The 1.367(b)-10 Regulations provide that in such a transaction appropriate adjustments shall be made as if S had distributed the property to acquire P stock (the “deemed distribution”) and P had contributed the same property to S (the “deemed contribution”), in each case as a separate transaction occurring prior to the triangular reorganization.² The 1.367(b)-10 Regulations do not apply, however, if:

- P and S are both foreign corporations and neither is a “controlled foreign corporation” (a “CFC”);
- S is a domestic corporation, the S stock that P holds is not a US real property interest (within the meaning of the US tax law), and P would not be subject to US tax on a dividend from S (the “no-US tax exception”); or
- The amount of gain recognized by US transferors on the exchange of the stock or securities of T for the stock of P (the “Section 367(a) amount”) is equal to or greater than the sum of the amount of the deemed distribution (i) treated as dividend income to P and (ii) treated as gain to P from the sale or exchange of property (clauses (i) and (ii) together, the “Section 367(b) amount”) (collectively, the “Priority Rule”).³

Additionally, the 1.367(b)-10 Regulations contain an anti-abuse rule (the “anti-abuse rule”) providing that “[a]ppropriate adjustments shall be made pursuant to [the 1.367(b)-10 Regulations] if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of [the 1.367(b)-10 Regulations].”⁴ The anti-abuse rule contains an example where S is “created, organized, or funded” in order to “avoid” the application of the 1.367(b)-10 Regulations with respect to the earnings and profits of a “related” corporation, and the example concludes that in such a case, the earnings and profits of S will be

¹ T.D. 9526 (May 19, 2011).

² Treasury Regulations Section 1.367(b)-10(b).

³ Treasury Regulations Section 1.367(b)-10(a)(2). The Section 367(a) regulations contain a corresponding priority rule in Treasury Regulations Section 1.367(a)-3(a)(2)(iv).

⁴ Treasury Regulations Section 1.367(b)-10(d).

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deemed to include the earnings and profits of such related corporation for purposes of determining the consequences of the adjustments provided in the 1.367(b)-10 Regulations.⁵

NOTICE 2014-32

The Notice states that the IRS is aware that the Priority Rule may facilitate inversion transactions that claim to avoid shareholder-level gain recognition under Section 367(a). The Transaction, as described above, would be structured so that the Section 367(b) amount exceeds the Section 367(a) amount, even though, under the current regulatory language, the Section 367(b) amount may include amounts of gain that are not at all subject to US tax. Furthermore, the Notice states that the IRS is concerned that taxpayers are interpreting the anti-avoidance rule “too narrowly”, which may have the effect of reducing the amount of US tax recognized under Section 367(b), thus reducing the effective cost of taking advantage of the Priority Rule. The Notice announces that both aspects of the Section 367(b) regulations will be modified.

A. THE PRIORITY RULES

The Notice states that the Regulations will modify the Priority Rules so that the 367(b) amount includes only the income or gain generated by the deemed distribution that would be subject to US tax or give rise to an income inclusion that is subject to US tax under the Subpart F rules (these rules generally require 10% US shareholders that (together) own more than 50% of a foreign corporation to include as taxable income particular types of the foreign corporation’s income currently (even if undistributed)). Accordingly, under the Regulations, the Priority Rule would generally be limited to situations where the entity-level taxable amount (not merely the entity-level recognition amount) is greater than the shareholder-level taxable amount.

B. THE ANTI-ABUSE RULE

The Notice observes that taxpayers may be interpreting the anti-abuse rule “too narrowly.” Accordingly, the Regulations will clarify that for purposes of application of the anti-abuse rule (i) a “funding” of S may occur before or after the triangular reorganization and includes “capital contributions, loans and distributions” (thus specifically covering the situation where S acquires P stock or securities in exchange for a note), and (ii) the earnings and profits of T may be taken into account regardless of whether T is related to P or S prior to the triangular reorganization. Thus, if the anti-abuse rule were applied to the Transaction as described above, USS’s earnings and profits would be deemed to include UST’s earnings and profits, thereby increasing the amount of US withholding tax due on USS’s deemed distribution to FP.

⁵ *Id.*

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C. OTHER TECHNICAL RULES

The Notice additionally provides rules to combat perceived technical abuses of the Section 367(b) regulations. In particular, the Regulations will remove the deemed contribution of the 1.367(b)-10 Regulations,⁶ which has the effect of increasing P's basis in its S stock. The Regulations will not, however, remove the deemed distribution.⁷ Accordingly, the Notice states that P's adjustment to the basis of its S stock will be determined under the normal rules related to reorganizations. Additionally, the Regulations will modify the 1.367(b)-10 Regulations to provide that the no-US tax exception (i) will not be available if P is a CFC, and (ii) will apply if the 367(b) deemed distribution does not result in a dividend that would be subject to US tax when P is not a CFC, S is a domestic corporation, and P's stock in S is not a US real property interest.

D. DATE OF APPLICABILITY

The Notice provides that the Regulations will be effective for transactions completed on or after April 25, 2014, but generally carves out transactions that are completed pursuant to a binding agreement entered into prior to such date. The Notice states, however, that "no inference is intended as to the treatment of transactions described" in the Notice under current law, and that the IRS may challenge such transactions under current law.

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⁶ Treasury Regulations Section 1.367(b)-10(b)(2).

⁷ Treasury Regulations Section 1.367(b)-10(b)(1).

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