SULLIVAN & CROMWELL LLP

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Corporate Inversion Transactions

IRS and Treasury Issue Temporary Regulations Intended to Limit Ability of Corporations to Invert and Reduce the Tax Benefits of Inversion Transactions

SUMMARY

On April 4, 2016, the Internal Revenue Service (the "IRS") and the Treasury Department (the "Treasury") issued new temporary regulations (the "Temporary Regulations") that address inversion transactions and certain post-inversion transactions.[1] Most notably, the Temporary Regulations add rules that limit so-called "serial inversions." As described in more detail below, these new rules disregard the value of a foreign corporation's unrelated domestic entity acquisitions for the purposes of determining the Ownership Fraction (defined below), if such unrelated acquisitions closed within the three-year period prior to signing a new deal.

The rules set forth in the Temporary Regulations are generally otherwise consistent with guidance previously issued in Notice 2014-52 (the "2014 Notice") and Notice 2015-79 (the "2015 Notice" and, together with the 2014 Notice, the "Notices"), subject to certain modifications, exceptions and additional limitations.

The new rules and modifications will apply to transactions that close on or after April 4, 2016. The other rules provided in the Temporary Regulations that were previously set forth in the Notices will generally apply as described in the original pronouncements.

BACKGROUND

Section 7874 generally targets "inversion" or "expatriation" transactions in which a foreign corporation or publicly traded foreign partnership (in each case, a "foreign acquiring corporation") acquires substantially all of the assets of a U.S. corporation or partnership (including by way of acquiring the ownership interests in such corporation or partnership) unless such foreign entity has "substantial business activities" in the jurisdiction of its organization.[2] Whether Section 7874 applies to a transaction therefore depends on the percentage of the combined entity that is held by the U.S. Stockholders (as defined below) (the "Ownership Fraction").

If at least 80 percent (by vote or value) of the foreign acquiring corporation is held by the former shareholders or partners of the expatriated entity "by reason of holding" stock or a capital or profits interest[3] in the expatriated entity (the "U.S. Stockholders") and the "substantial business activities" test is not satisfied, the foreign acquiring corporation is treated as a domestic entity for U.S. tax purposes.[4]

If at least 60 percent (by vote or value), but less than 80 percent, is held by the U.S. Stockholders and the "substantial business activities" test is not satisfied, the foreign acquiring corporation is respected as foreign, but is subject to various tax disadvantages, including U.S. tax on any "inversion gain" recognized in the ten years following the transaction (such transactions, "60-80 Transactions").[5] The majority of announced transactions were such 60-80 Transactions, although since the Notices, which focused on transactions in this range, there have been more transactions where the Ownership Fraction is below 60 percent.

THE REGULATIONS

The Temporary Regulations add the new "serial inversions" rule and otherwise generally implement rules announced in the Notices, subject to certain modifications and additions. The following summary is a review of the relevant updates provided in the Temporary Regulations.

A. LIMITING THE ABILITY OF U.S. CORPORATIONS TO SATISFY THE OWNERSHIP THRESHOLD NECESSARY FOR AN EXPATRIATION TO BE RESPECTED

1. "Serial" Inversions

The most notable new anti-inversion rule in the Temporary Regulations addresses so-called "serial inversions." This rule is intended to address a case where the foreign acquiring corporation previously acquired one or more domestic entities—in effect making the foreign acquiring corporation larger and the Ownership Fraction easier to satisfy in a subsequent acquisition. Under the new rule, in general, stock of the foreign acquiring corporation will be disregarded (for the purposes of determining the Ownership Fraction) to the extent such stock is attributable to the value of the domestic acquisitions that occurred within three years of the signing date (*not* the closing date) of the new domestic entity acquisition. Specifically, the rule excludes from the denominator of the Ownership Fraction the foreign acquiring corporation stock received in a prior domestic entity acquisition (less certain adjustments made for redemptions), based on the value of such stock at the closing of the new domestic entity acquisition. This rule only applies to a prior domestic entity acquisition where the Ownership Fraction was greater than five percent or the fair market value of the foreign acquiring corporation stock received by the U.S. Stockholders in such acquisition was greater than $50 million. Notably, prior domestic entity acquisitions that are not "inversion transactions" (i.e., where the relevant Ownership Fraction in respect of such prior transaction is less than 60 percent) are not excluded, although prior acquisitions made for cash would generally have no impact (since there would be no stock issued that would need to be excluded).

This rule will generally apply to transactions that close on or after April 4, 2016.

2. Multiple-Step Acquisitions

The Temporary Regulations also provide a new rule intended to prevent a series of related transactions that, when taken together, could cause an indirect acquisition of a domestic entity and avoid the application of Section 7874. In general, Section 7874 regulations provide an exception (the "Foreign Entity Exception") that an acquisition of a foreign entity is not treated as an acquisition of a domestic subsidiary of the foreign entity (because such a domestic entity is already expatriated). The Temporary Regulations would turn off the Foreign Entity Exception where a domestic entity is first acquired by an initial foreign entity (which may satisfy the "substantial business activities" test or not be subject to the Top Hat rule, as described below) and that initial foreign entity is, pursuant to the same plan or series of related transactions, subsequently acquired by a second foreign acquiring corporation. The new rule would treat the second foreign corporation as acquiring a domestic entity and be subject to the requirements of Section 7874 (i.e., having to satisfy the "substantial business activities" test or Top Hat rule).

This rule will generally apply to transactions that close on or after April 4, 2016.

3. "Top Hat" in a Third Jurisdiction

Prior to the 2015 Notice, many cross-border transactions between a domestic entity and a foreign company (a "Foreign Target") established a "top hat" parent company in a third jurisdiction (a "Top Hat") that served as the foreign acquiring corporation in the transaction. This may be done for a variety of reasons, but the 2015 Notice would, in many instances, disregard all stock issued by the Top Hat to the Foreign Target shareholders in the combination for the purposes of calculating the Ownership Fraction, which could result in the Top Hat being treated as a domestic corporation. This can be a surprising result where the "headline" ownership percentage attributable to the Foreign Target, as understood by the market, is far from the 80-percent threshold. In effect, in many cases, the 2015 Notice (as implemented by the Temporary Regulations) lowers the 80-percent threshold for transactions with a Top Hat to 60 percent.

As provided in the Temporary Regulations, which are generally consistent with the 2015 Notice, this rule applies if (i) in a transaction related to the acquisition, a Top Hat directly or indirectly acquires substantially all of the properties held directly or indirectly by the Foreign Target[6] (the "Foreign Target Acquisition"); (ii) the tax residence[7] of the Top Hat is not the same as that of the Foreign Target, as determined before the Foreign Target Acquisition or any transaction related thereto (treating a change of "management and control" as a transaction for this purpose); and (iii) the transaction is a 60-80 Transaction (without taking into account modifications to the Ownership Fraction pursuant to this rule).[8] For the purposes of determining whether there could be a Foreign Target Acquisition, the Temporary Regulations replace a "60 percent gross value" test in the 2015 Notice with a "continuity of interest" test, which generally requires that 60 percent or more of the stock of the Top Hat be held by former shareholders of the Foreign Target, without taking into account U.S. Stockholders' ownership of the Top Hat stock.

The Top Hat rule will generally apply to acquisitions that close on or after November 19, 2015, and taxpayers may elect to apply the revised provisions of this rule included in the Temporary Regulations to transactions that close before April 4, 2016.

4. Foreign Corporation That Is a "Cash Box"

The 2014 Notice announced that future regulations will provide a "cash box" rule whereby a ratable portion of stock will be disregarded for the purposes of the Ownership Fraction to the extent that more than 50 percent of the existing assets of the foreign corporation are "nonqualified property" (i.e., liquid assets, including cash, marketable securities and intercompany obligations). Under the 2014 Notice, assets of an "active" bank or financing business for the purposes of the "passive foreign investment company" ("PFIC") and "controlled foreign corporation" ("CFC") rules and assets of an "active" insurance company for the purposes of the CFC rules are not nonqualified property. The 2015 Notice corrected this rule to provide that assets of foreign insurance companies that are "active" for the PFIC rules are also not treated as nonqualified property for this purpose. Further, the 2015 Notice clarified that property held by a domestic insurance company (subject to U.S. taxation, but wholly owned by a foreign acquiror) generally would not be nonqualified property for this purpose.

The Temporary Regulations implement this rule generally as described and modified by the Notices. In addition, the Temporary Regulations provide a "de minimis" exception to the "cash box" rule. The de minimis exception in the Temporary Regulations specifically provide that the "cash box" rule does not apply if (i) the U.S. Stockholders hold less than five percent of the combined company as determined by the Ownership Fraction (without regard to the "cash box" rule) and (ii) the U.S. Stockholders hold less than five percent of the stock of each member of the "expanded affiliated group" ("EAG"). In addition, the Temporary Regulations provide a look-through rule for partnerships in which the foreign corporation owns more than 50 percent (by value) of the interests.

The "cash box" rule generally applies to acquisitions completed on or after September 22, 2014. However, the new rules provided in the Temporary Regulations, such as the "de minimis" exception and the look-through rule for partnerships, will apply to acquisitions completed on or after April 4, 2016.

5. "Skinny-Down" Distributions

A domestic entity contemplating an inversion may decrease its value before the inversion by distributing property to its shareholders in order to reduce the Ownership Fraction, such that the combined company could avoid the application of Section 7874, or avoid the shareholder-level tax under Section 367(a)(1). To limit the effectiveness of these pre-transaction distributions (also known as "skinny-down" distributions), the 2014 Notice announced a rule to be provided in future regulations that would, for the purposes of determining the Ownership Fraction, disregard (and require to be added back) certain pre-transaction distributions by the domestic entity, whether or not such distributions were made with an avoidance purpose. The 2015 Notice provided a "de minimis" exception to this rule.

The determination of "non-ordinary course distributions" under the Temporary Regulations is complex but is generally more certain in its application than adumbrated in the Notices. The Temporary Regulations clarify that the non-ordinary course distribution rule applies solely for the purposes of determining the ownership percentage by *value* (not by vote). In addition, the Temporary Regulations jettisoned the highly unworkable "taxable year" concept originally proposed in the 2014 Notice and look to just calendar periods to determine non-ordinary course distributions. Further, the Temporary Regulations provide special adjustments for short periods.

Distributions generally include all distributions on stock, such as share buybacks and spin-offs under Section 355.[9] However, the Temporary Regulations provide that distributions for this purpose do not include certain deemed distributions, such as stock distributions. In the context of a distribution under Section 355, a special rule provides that, if the "SpinCo" is larger than the distributing corporation, SpinCo would be deemed to have distributed its former parent. The value of the property distributed will be determined on the date of the distribution.

The Temporary Regulations also capture distributions by a "predecessor" entity of the domestic entity acquired in an inversion transaction, which, for example, may have undergone a reorganization in advance of the expatriation to avoid this non-ordinary course distribution rule. Accordingly, for purposes of calculating non-ordinary course distributions, distributions by an entity that is acquired by or combined with the domestic entity will be included in determining the non-ordinary course distribution calculations.

The Temporary Regulations provide a "de minimis" exception, consistent with the announcement in the 2015 Notice. The exception provides that a domestic entity is not required to "add-back" non-ordinary course distributions if (i) the Ownership Fraction (without taking into account this non-ordinary course distribution rule and certain other modifications) is less than five percent (by vote and value), and (ii) following the transactions, U.S. Stockholders, in aggregate, own less than five percent (by vote and value) of the stock of each EAG member.

The non-ordinary course distribution rule will generally apply to acquisitions completed on or after September 22, 2014. The "de minimis" exception will apply to transactions that close on or after

November 19, 2015 and the new clarifying rule in the Temporary Regulations with respect to distributions that qualify under Section 355 will apply to transactions that close on or after April 4, 2016. However, taxpayers may elect to apply the exception and the clarification to transactions that closed on or after September 22, 2014.

B. POST-INVERSION LIMITATIONS

1. "Hopscotch" Transfers of Controlled Foreign Corporation Earnings and Profits

A U.S. shareholder of a foreign corporation (including a CFC) generally defers recognition of current U.S. tax on its pro rata share of the CFC's active business income until that income is repatriated. However, Section 956 subjects U.S. shareholders to tax on their pro rata share of the CFC's deferred profits when the CFC makes investments in certain U.S. property. The 2014 Notice observed that, prior to the 2014 Notice, an inversion transaction may permit the foreign acquiring corporation (after the combination) to circumvent Section 956 and access the CFC's profits. For example, a CFC may make a loan directly to the new foreign parent (a so-called "hopscotch" loan), which, under prior law, would not be subject to the rules of Section 956. The IRS and Treasury announced in the 2014 Notice that future regulations would provide (solely for the purposes of Section 956) that any obligation or stock of a foreign-related person acquired by a CFC within 10 years after the inversion will be treated as "U.S. property" and, thus, would give rise to taxable income to the U.S. shareholder of the CFC (the acquired domestic entity).

The Temporary Regulations implement the limitation announced in the 2014 Notice, subject to certain modifications. Notably, if a CFC of a domestic entity acquires stock or obligations of a "prospective" foreign acquiring corporation "in a transaction related to the inversion transaction" (i.e., prior to closing), the CFC would be treated as holding "U.S. property" with respect to such stock or obligations.

Other than the modifications provided in the Temporary Regulations, which will apply to obligations or stock acquired on or after April 4, 2016, the "hopscotch" rule will apply to obligations or stock acquired on or after September 22, 2014, but only to inversion transactions that close on or after September 22, 2014.

2. "Asset-Dilution" of Controlled Foreign Corporations

The Temporary Regulations added a new "asset-dilution" rule to the basket of limitations provided in the Notices (and implemented by the Temporary Regulations) with respect to expatriated CFCs, such as limitations on "de-controlling" and "stock-dilution." The Temporary Regulations require, subject to certain exceptions, an expatriated CFC to recognize all built-in gain in a transfer of assets to a related foreign corporation (that is not a CFC), even if such transfer would qualify as tax-free under Section 351. This "asset dilution" rule effectively puts a toll charge on asset transfers by expatriated CFCs to related non-CFCs.

This rule applies to transfers completed on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014.

ADDITIONAL GUIDANCE RELEASED

In addition, on April 4, 2016, the IRS and the Treasury issued a notice of proposed rulemaking that, if finalized, will cause very significant changes in the structuring of debt capitalization of U.S. subsidiary groups owned by foreign corporations (and of foreign subsidiaries owned by U.S. corporations). The proposed regulations provide that certain related-party debt would be recharacterized as equity, or as part-debt and part-equity, if, for example, such debt were issued to finance a related-party acquisition or such debt was distributed to a related corporate shareholder. Although the main purpose of the proposed regulations may have been to negate one of the tax benefits of an inversion, their reach extends far beyond the context of inversions and will have an impact on the tax planning of multinational corporations and investments. The proposed regulations will apply to debt issued on or after April 4, 2016; however, such debt will retain its characterization as debt until 90 days after the final regulations are published.

A separate memorandum published by Sullivan & Cromwell LLP entitled "IRS Issues Proposed Regulations Intended to Limit Earnings Stripping but Which—if Finalized—Would Broadly Change the U.S. Tax Treatment of Related-Party Indebtedness" discussing these new rules was made available today.

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ENDNOTES

1 For additional background on Section 7874, please see the Sullivan & Cromwell LLP publications addressing Section 7874 and related guidance, which may be obtained by following the instructions at the end of this publication.

2 An expanded affiliated group will have "substantial business activities" in the relevant foreign country after the acquisition only if at least 25 percent of the employees, assets, and income of the expanded affiliated group are located in, or in the case of income, derived from, that relevant foreign country. *See* § 7874(a)(2)(B)(iii); Treas. Reg. § 1.7874-3T(b).

3 For ease of reference, we will refer to all such interests as "stock."

4 *See* § 7874(b).

5 "Inversion gain" includes any income or gain recognized by reason of the inversion transaction (which includes gain recognized on the transfer or sale of assets to the non-U.S. corporation) and certain gain and licensing income recognized by an expatriated entity during the ten-year period. *See* § 7874(d)(2), (f).

6 If multiple Foreign Targets in the same Foreign Target jurisdiction are acquired, then they will be treated as a single entity.

7 Although not clear, this determination would be made under applicable foreign law. It remains unclear how the residence would be determined if tax residence is possible in more than one jurisdiction.

8 *See* § 1.7874-9T(c).

9 It is unclear whether distributions on or redemptions of convertible debt would be treated as distributions with respect to a corporation's stock for this purpose.

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