Department of the Treasury and the Internal Revenue Service to Issue Regulations Limiting Taxpayers' Ability to Benefit from Undertaking "Inversion Transactions"

Summary

On September 22, 2014 the Department of the Treasury and the Internal Revenue Service provided official notice to taxpayers of their intention to issue regulations limiting taxpayers' ability to benefit from undertaking "inversion transactions." (Notice 2014-52 or the Notice). The Notice indicates that the regulations generally will be effective with respect to inversion transactions completed after September 21, 2014, and related tax planning strategies implemented by companies that inverted after that date.[1]

We expect the regulations will deter certain, but not all, tax-motivated inversion transactions. In other cases, benefits will be reduced, as will opportunities to finance transactions with deferred earnings held by an inverted U.S. company's foreign subsidiaries (i.e., foreign trapped cash). The Notice indicates Treasury's plans to issue additional guidance to deter "earning stripping" strategies to reduce an inverted company's U.S. taxable income. In light of the Notice, boards of directors may be reluctant to take account of pro-forma tax savings and reduced financing costs in assessing deal valuations and terms.

Taxpayers, including hedge funds and other investors, as well as any company considering strategies that could be subject to the inversion rules, should seek guidance in gauging the impact of the Notice on prospective transactions. In this regard, the potential tax planning opportunities vary depending on the tax profile of the parties and business projections.

Background and Analysis

In an inversion, a U.S. company's ownership is altered so that the U.S. company becomes a wholly-owned subsidiary of an acquiring non-U.S. parent company. In contrast with more conventional U.S. acquisitions by a non-U.S. acquirer, "inversions" describe transactions that result in former U.S. target shareholders owning at least 60 percent of the non-U.S. acquirer. Typically, the acquirer is situated in a non-U.S. jurisdiction (e.g., Ireland, the United Kingdom or Switzerland) that offers a preferential tax regime (i.e., low effective tax rates and broad exclusions for income earned by or received from foreign subsidiaries) and has entered into an income tax treaty with the United States.

Inversions have offered a range of planning opportunities to (i) reduce a U.S. company's taxable income by making tax deductible payments, often interest or royalties, to a non-U.S. acquiring group member, and (ii) to allow the non-U.S. group to acquire non-U.S. assets, including acquisitions of U.S. target foreign subsidiary equity or assets. Taxpayers also have used inversions to access offshore "trapped cash" (held by the U.S. target's foreign subsidiaries). Prior to an inversion (and related planning), the repatriation of these deferred foreign earnings would generate U.S. taxable income and could disturb favorable accounting treatment that brings in foreign earnings without a haircut for the U.S. tax costs of repatriation so long as the company pledges to permanently invest these earnings abroad.

Significantly, the Notice announces measures to curb tax efficient access to the U.S. target's offshore trapped cash, including if that cash is loaned to the foreign acquiring group. The Notice also announces prospective

[1] In one instance, new rules limiting access to the earnings of non-U.S. subsidiaries by non-U.S. affiliates will apply for transactions after September 21, 2014, regardless of whether an inversion transaction has occurred.

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restrictions on post-inversion transfers of a U.S. target's controlled foreign corporation shares as well as those corporation's assets. This type of planning had been used both to remove assets from the U.S. tax net and to facilitate tax efficient access to trapped foreign tax. In sum, these measures impede inversions by public multinational corporations that have faced mounting commercial pressure to utilize their offshore earnings.

Other provisions in the Notice expand the situations to which the anti-inversion rules apply. To date, the anti-inversion provisions have not directly covered transactions by which U.S. target companies reduce their size by distributions to or redemptions of shareholders. If these transactions occur within 36 months of a combination, the Notice now takes account of these transactions in determining whether U.S. shareholders of the U.S. target company should be viewed as staying below the post-combination ownership thresholds that trigger various anti-inversion rules. Similarly, the Notice classifies certain transactions as inversions if a U.S. target combines with a non-U.S. company that holds mainly liquid assets or intellectual property but does not conduct active business operations. The aim in both cases is to subject combinations to the anti-inversion rules if circumstances suggest that tax motivations for the combination may be relatively significant as compared to other business objectives.

The Notice covers a broad range of tailored provisions to address the issues described above. We would welcome the opportunity to discuss the Notice and its implications, as well as related tax and commercial matters.

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