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Treasury and IRS Tighten Anti-Inversion Rules in Latest Round of Guidance But Take No Action on Earnings Stripping

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On Thursday, November 19, 2015, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) published Notice 2015-79, announcing their intention to issue regulations that will (1) expand the application of the anti-inversion rules under section 7874 and (2) limit the tax benefits associated with inversion transactions. Notice 2015-79 supplements last year's Notice 2014-52, in which Treasury and the IRS also announced their intention to issue new anti-inversion regulations (*see* previous Miller & Chevalier client alert here). Treasury and the IRS have not yet issued regulations pursuant to Notice 2014-52, and Notice 2015-79 makes certain changes and clarifications to the rules described in Notice 2014-52. Notice 2015-79 does not include new limitations on interest deductions, or earnings stripping, by expatriated entities.

In general, Notice 2015-79 applies prospectively to acquisitions and post-inversion planning occurring on or after November 19, 2015, although in the case of certain post-inversion planning, the guidance applies only to taxpayers that have undertaken inversion transactions on or after September 22, 2014.

Background

Section 7874 applies to the acquisition of a U.S. target by a foreign acquirer if three criteria are satisfied: (1) the foreign acquirer acquires substantially all of the property of the U.S. target; (2) the former shareholders of the U.S. target acquire at least 60 percent of the stock of the foreign acquirer by reason of their shareholdings in the U.S. target (the ownership test or ownership percentage) and (3) after the transaction, the foreign acquirer (taking into account its expanded affiliated group (EAG)) does not have substantial business activities in its country of organization (the substantial business activities test).

If the ownership percentage is at least 60 percent, but less than 80 percent, the transaction is considered an inversion and section 7874 denies the use of certain tax attributes (such as net operating loss carryforwards) to reduce taxes arising from the "inversion gain" that the U.S. target recognizes on post-inversion outbound transfers or licenses of property (including stock). Inversion gain is treated as U.S. source income, and it is therefore taxed without offset by foreign tax credits. The rules limiting the use of tax attributes to reduce tax on inversion gain apply for a 10-year period following an inversion transaction. If the ownership percentage is at least 80 percent, section 7874 deems the foreign acquirer to be treated as a U.S. corporation for U.S. tax purposes.

New Barriers to Inversion Transactions

Section 2 of Notice 2015-79 describes regulations that Treasury and the IRS intend to issue that would modify the substantial business activities test and the ownership test in ways that would expand the reach of section 7874.

Tax Residence Standard for Substantial Business Activities Test

A foreign acquisition of a U.S. target is not considered an inversion transaction if, after the acquisition, the EAG of the foreign acquirer has substantial business activities in the country in which the foreign acquirer is organized. *See* section 7874(a)(2)(B)(iii).[1] If the country in which the foreign acquirer is organized determines tax residency based on criteria other than the place of organization, the foreign acquirer may not be subject to tax in that country. In Notice 2015-79, the Treasury and the IRS announced they will issue regulations requiring that the foreign acquirer be subject to tax as a resident of the country where the EAG claims substantial business activities. Treasury and the IRS state that the substantial activities test is "premised on the foreign acquiring corporation being subject to tax as a resident of the relevant foreign country," and that it should not apply to permit the parent of an EAG "to replace its U.S. tax residence with tax residence in any other country (or, in certain cases, in no other country), without regard to the location of any substantial business activities conducted by the EAG." Under the new rules, the substantial business activities test cannot be satisfied unless the foreign acquirer is a tax resident of the country in which the EAG has substantial business activities. It appears that this requirement is in addition to, and therefore not a substitute for, the statutory requirement that the foreign acquirer be organized in the country where the EAG has substantial business activities.

Third-Country Transactions

Treasury and the IRS also announced their intention to issue regulations designed to curtail cross-border acquisitions that are structured by establishing a new foreign parent corporation for the combined group with a tax residence that is different from that of the existing foreign corporation (third-country transactions). Treasury and the IRS take the view that a third-country parent "typically is chosen to facilitate the use of low- or no-taxed entities to erode the U.S. tax base following the acquisition." Consistent with the changes to the substantial business activities test described above, the focus of the government's concern with third-country transactions is on the tax residence of the foreign parent rather than its place of organization.

Notice 2015-79 acknowledges that Congress adopted an 80-percent threshold under section 7874(b) because a transaction where the shareholders of the foreign acquirer will own more than 20 percent of the combined entity has a "sufficient likelihood of a non-tax business purpose," but states that in third-country transactions, "the likelihood that there is sufficient non-tax business purpose for replacing the U.S. parent with a foreign parent is significantly lower than Congress assumed in establishing the 80-percent threshold." Accordingly, Notice 2015-79 provides that the new regulations will disregard certain stock in the new third-country parent in applying the ownership test. In particular, the regulations will disregard stock in the new third-country parent owned by the former shareholders of the foreign merger partner if four requirements are met:

1. The foreign acquiring corporation acquires substantially all the properties of a foreign target corporation (applying the principles of section 7874(a)(2)(B)(i) and Treas. Reg. § 1.7874-2(c)) (the foreign target acquisition);
2. The gross value of all property acquired in the foreign target acquisition exceeds 60 percent of all foreign group property;
3. The tax residence of the foreign acquiring corporation is not the same as the foreign target corporation, as determined before the foreign target acquisition and any related transactions (including for this purpose a change in the location of management and control); and
4. Not taking into account these rules, the ownership percentage is at least 60 but less than 80.

Avoidance Property

In previous guidance (Notice 2009-78 and Treas. Reg. § 1.7874-4T), Treasury and the IRS addressed transactions in which investors used cash or other liquid assets (nonqualified property) to inflate the value of the foreign acquirer and thereby reduce the ownership fraction. Existing regulations provide that nonqualified property includes "any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874." *See* Treas. Reg. § 1.7874-4T(i)(7)(iv). In Notice 2015-79, Treasury and the IRS express a concern that, based on the example provided in the existing temporary regulations, taxpayers have interpreted this category of "avoidance property" in an excessively narrow way to apply only to property, such as stock, that is used to facilitate an indirect transfer of cash or other liquid assets to the foreign acquiring corporation.

Notice 2015-79 states that new regulations will clarify that avoidance property is any property acquired with a principal purpose of avoiding section 7874, "regardless of whether the transaction involves an indirect transfer of specified nonqualified property." In support of a broad interpretation of this anti-avoidance rule, Notice 2015-79 points to section 7874(c)(4), which disregards any transfer of property that is "part of a plan a principal purpose of which is to avoid the purposes of" section 7874. Notice 2015-79 includes an example intended to illustrate this clarification to the avoidance rule, but the example merely provides that business assets that a foreign acquirer acquires in exchange for 25 percent of its stock, "with a principal purpose of avoiding section 7874," is nonqualified property. Because the statement that the foreign acquirer had a principal purpose of avoiding section 7874 is included in the facts of the example, it is unclear what facts are relevant to determining whether this avoidance purpose exists in a situation where the property consists solely of business assets.

New Limits on Post-Inversion Planning

Section 3 of Notice 2015-79 describes regulations that Treasury and the IRS intend to issue to limit the U.S. tax benefits of certain post-inversion transactions, in particular transactions that would permit tax-efficient access to the earnings of controlled foreign corporations (CFCs) of the U.S. target.

Expanded Definition of Inversion Gain to Include Indirect Transfers

Treasury and the IRS announced they intend to issue regulations that will characterize the gain realized from certain indirect transfers as "inversion gain" that cannot be offset by tax attributes under section 7874. Notice 2015-79 observes that because the statutory definition of inversion gain in section 7874(d)(2) applies only to transfers or licenses of property by an expatriated entity, indirect transfers of property by a CFC of the expatriated entity do not give rise to inversion gain. Such indirect transfers or licenses may result in income inclusions to the expatriated entity under the anti-deferral rules of Subpart F, and the expatriated entity may use tax attributes to offset these income inclusions because they are not considered inversion gain. The new regulations will provide that inversion gain includes any income or gain recognized by the expatriated entity from an indirect transfer or license of property (other than inventory), including income or gain the expatriated entity takes into account under the anti-deferral rules of Subpart F. Thus, where a CFC owned by an expatriated entity transfers appreciated property (including stock) or licenses property to the foreign parent or other specified related person in a taxable transaction, any resulting gain the expatriated entity must include in its income under Subpart F will become inversion gain, and the expatriated entity will be unable to use its tax attributes to reduce its tax on such gain. It is not clear whether this guidance will reach amounts other than those included under the Subpart F rules.

Application of Section 367(b) to Dilution Transactions

Treasury and the IRS also intend to address post-inversion planning involving certain non-recognition transactions that dilute the U.S. shareholder's interest in CFCs. Regulations under Treas. Reg. § 1.367-4(b) currently require a U.S. shareholder involved in a foreign-to-foreign non-recognition transaction to include in its income as a deemed dividend the "section 1248 amount" if the exchange results in the U.S. shareholder no longer being a "section 1248 shareholder" (*i.e.*, a person who owns 10 percent or more of the combined voting power in a CFC). The section 1248 amount is generally any gain realized on the exchange to the extent of the CFC's earnings and profits. While Notice 2014-52 announced that new regulations would require the U.S. shareholders to include in income the section 1248 amount regardless of whether or not they maintained their status of section 1248 shareholders in a CFC following the non-recognition transaction (subject to certain exceptions), Notice 2015-79 announces that the regulations will also require U.S. shareholders to pay tax on *all* of the built-in gain realized, not limited by the amount of earnings and profits attributable to the U.S. shareholder's stock in the CFC. According to Notice 2015-79, such a rule is necessary in order to prevent the avoidance of U.S. tax on unrealized gain in property held by CFCs owned by the expatriated entity, particularly in cases where the CFC holds "valuable self-developed intangible property that has not yet been brought to market and therefore has not generated any significant earnings and profits."

Changes to Notice 2014-52

Section 4 of Notice 2015-79 also made certain "corrections" and "clarifying changes" to the rules set forth in Notice 2014-52. Two of these are in response to comments and intended to be helpful to taxpayers. First, with respect to the rule in Notice 2014-52 intended to prevent the use of passive assets or "nonqualified property" of the foreign acquirer to reduce the ownership fraction, Treasury and the IRS have provided exceptions for foreign acquirers engaged in the insurance or banking business. Under these exceptions, the definition of foreign group nonqualified property will not include assets that satisfy the insurance exception for purposes of the passive foreign investment company (PFIC) rules (section 1297(b)(2)) or property held by a domestic subsidiary that is subject to tax as an insurance company or gives rise to income that would satisfy the active finance exception of subpart F (section 954(h)). Second, with respect to the rule in Notice 2014-52 disregarding non-ordinary course (so-called "skinny down") distributions, Notice 2015-79 adds a *de minimis* exception consistent with the *de minimis* exception in Treas. Reg. § 1.7874-4T(d)(1). This *de minimis* exception will apply if the ownership fraction (without regard to the rules for nonqualified property) is less than five percent and former shareholders of the domestic corporation in the aggregate own less than five percent of any member of the EAG that includes the foreign acquirer.

Finally, with respect to the rules in Notice 2014-52 that recharacterize transactions intended to "de-control" or dilute the ownership of CFCs by expatriated entities, Notice 2015-79 "clarifies" that the "small dilution exception" to these rules applies only if the *percentage* (rather than the amount or value) of CFC stock owned by the expatriated entity is reduced by less than 10 percent.

Effective Dates

In general, Notice 2015-79 applies prospectively -- that is, to tax benefits that will be claimed in the future. The regulations that will affect the operation of the substantial business activities test and the ownership test, which affect whether an acquisition is treated as an inversion transaction under section 7874, will be effective for acquisitions occurring on or after November 19, 2015. The regulations that affect post-inversion planning will apply to transfers occurring on or after November 19, 2015, but only to taxpayers that undertook an inversion transaction on or after September 22, 2014 (the date of Notice 2014-52). Taxpayers may elect to apply the favorable rules modifying Notice 2014-52 to acquisitions completed before November 19, 2015.

Notice 2015-79 does not contain any grandfather provision and will therefore apply to inversion transactions that are pending but have not closed as of the date of Notice 2015-79. Notice 2015-79 states that no inference is intended as to the treatment of transactions described therein under current law, and that the IRS may challenge such transactions.

Requests for Comment and Possibility of Future Guidance

Notice 2015-79 restates the intention to issue additional guidance to limit inversion transactions that are contrary to the purposes of section 7874 and the benefits of post-inversion tax-avoidance transactions. In particular, Treasury and the IRS are continuing to consider guidance to address strategies that avoid U.S. tax on U.S. operations by "stripping" U.S. source earnings to lower-tax jurisdictions, including through intercompany debt. Notice 2015-79 renews the request for comments on these items. Notice 2014-52 provided that earnings stripping guidance limited to inverted groups would apply to any group that completed an inversion transaction on or after September 22, 2014.

The guidance announced in Notice 2014-52 and Notice 2015-79 reflects the desire by Treasury and the IRS to use their power to regulate, as well as the threat of potential regulation, to deter inversion transactions. This guidance is constrained by the statutory guideposts in section 7874, which permit inversion transactions so long as certain conditions are met. The regulatory landscape remains uncertain following Notice 2015-79, in particular regarding what if any additional guidance will be issued to address earnings stripping. These uncertainties are likely to persist. While Treasury has been outspoken about the need for congressional action to curb inversion transactions, there is no consensus on whether it is preferable to reform the U.S. tax rules to make them more consistent with international norms, or to continue to tighten section 7874.

1. Under regulations, substantial business activities is defined as 25 percent of the EAG's employees, assets and income. *See* Treas. Reg. § 1.7874-3

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