

CORPORATE INVERSIONS

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Background

- In a typical inversion, a U.S. multinational combines with a foreign corporation, and the ultimate parent of the surviving entity is a foreign corporation.
- The U.S. tax treatment of a multinational corporate group differs significantly depending upon whether the ultimate parent is a U.S. or a foreign corporation.
- Under U.S. tax law, the tax residence of a corporation is generally determined based upon the state of incorporation, without regard to where it is “managed and controlled.” Accordingly, a corporation incorporated in the U.S. is classified as a U.S. corporation for U.S. tax purposes and a corporation incorporated abroad is generally classified as a foreign corporation for U.S. tax purposes (subject to an exception discussed below).

U.S. Taxation of Domestic Corporations

- The U.S. employs a “worldwide,” rather than a “territorial,” tax system, under which a domestic corporation is generally taxed on all income, regardless of whether the income is derived in the U.S. or outside the U.S.
- Income derived by a U.S. parent from operations conducted by its controlled foreign corporations (“CFCs”) is generally subject to U.S. tax when the income is distributed as a dividend to the U.S. parent, assuming U.S. anti-deferral rules (Subpart F and Passive Foreign Investment Company (“PFIC”)) do not apply.

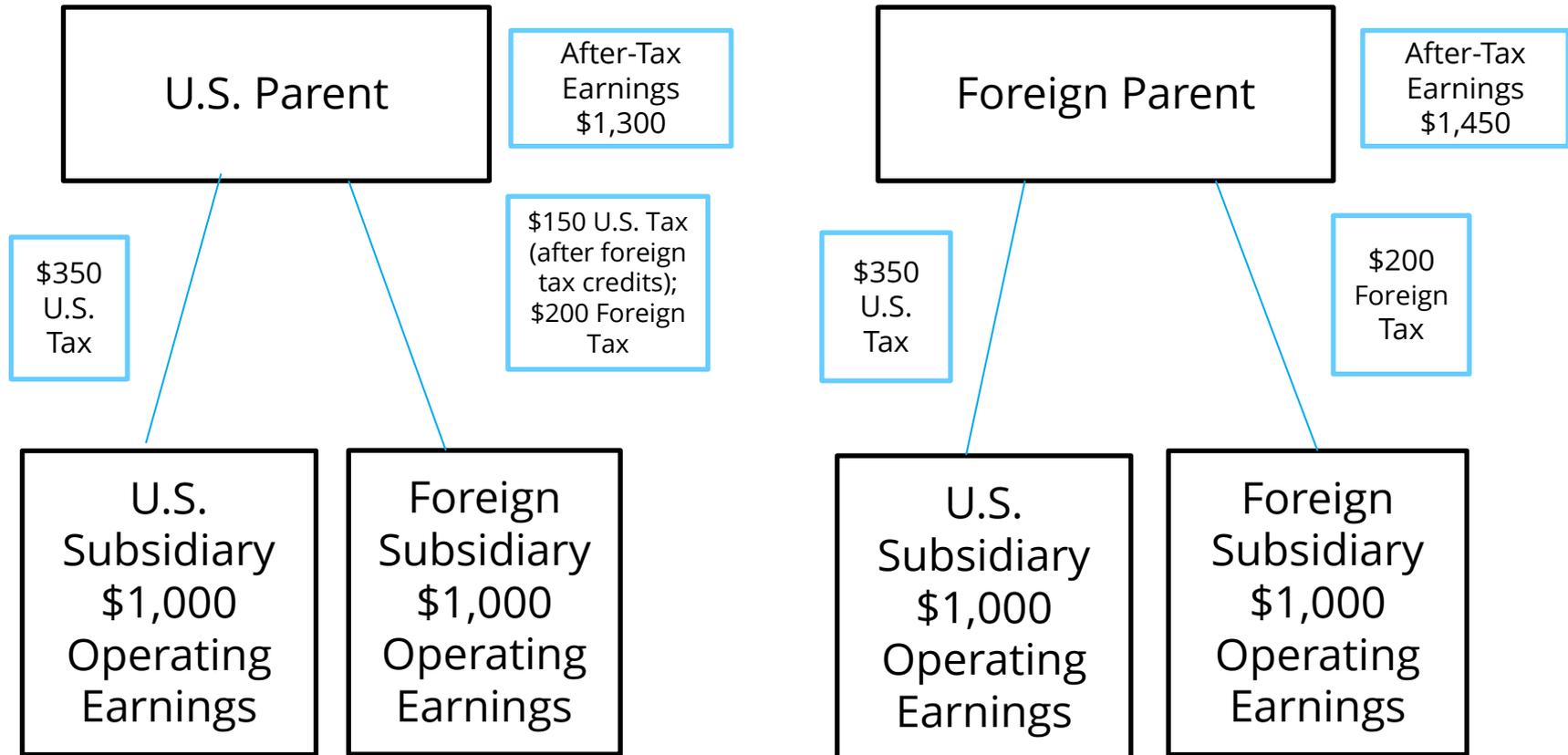
U.S. Taxation of Domestic Corporations

- U.S. multinationals desire to access cash held by their CFCs without incurring U.S. tax. A loan from a CFC to its U.S. parent triggers U.S. tax under Section 956 of the Internal Revenue Code of 1986, as amended (the “Code”), subject to limited exceptions.
- U.S. multinationals defer U.S. tax with respect to earnings derived by their CFCs only if they retain the cash offshore. U.S. multinationals also avoid a deferred tax liability for financial accounting purposes if the CFCs’ earnings are considered “permanently reinvested earnings.”
 - U.S. multinationals are estimated to hold \$2 trillion in cash offshore, which is “trapped” to a large degree.

U.S. Taxation of Multinational Corporate Group Headed by a Foreign Corporation

- While a multinational corporate group headed by a U.S. corporation is generally subject to U.S. tax on its worldwide income, subject to the potential availability of the foreign tax credit and U.S. tax deferral, a multinational corporate group headed by a foreign corporation is generally subject to U.S. tax only with respect to (i) the taxable income of U.S. subsidiaries, (ii) U.S. “effectively connected income” of foreign affiliates, and (iii) U.S.-source FDAP (“fixed and determinable, annual or periodical”) income of foreign affiliates.

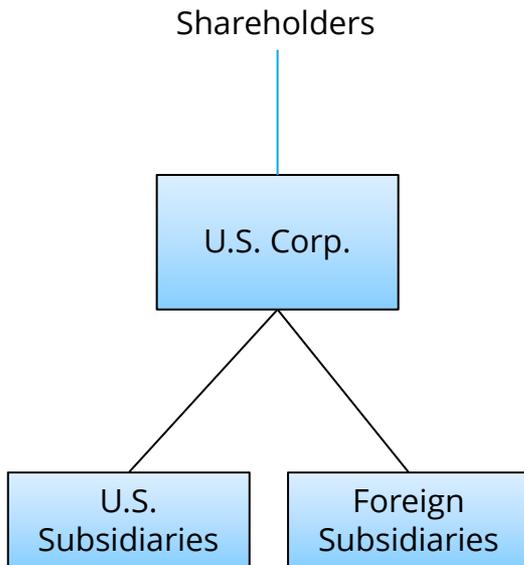
Illustration of Tax Savings Realized as a Result of Having a Multinational Group Headed by a Foreign Corporation



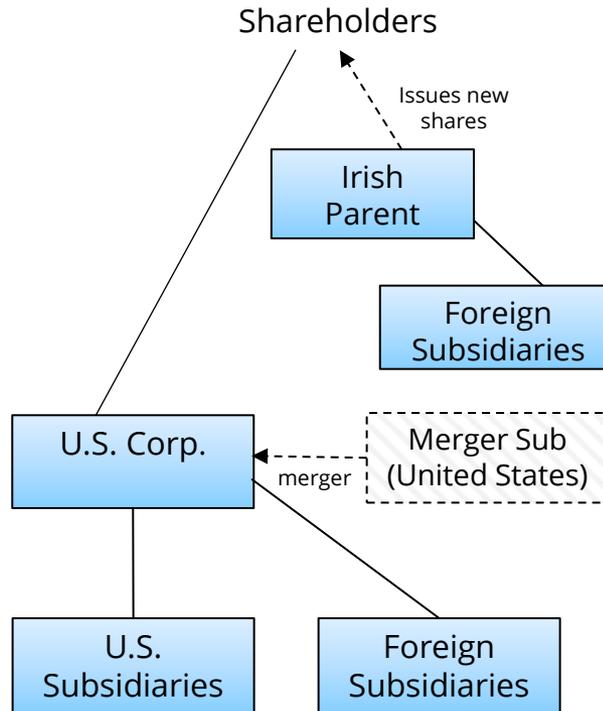
* Assumed foreign tax rate of 20%

Illustration of Inversion

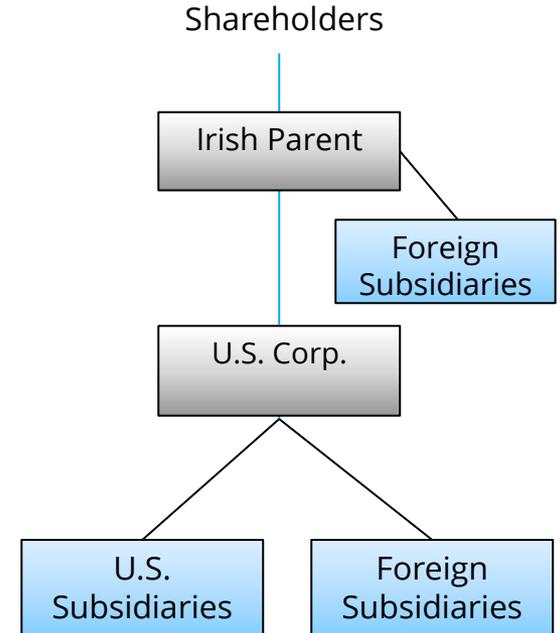
Original Structure



Inversion Transaction



Post-Inversion Structure



Common Post-Inversion Restructurings

- In many inversions, the multinational corporate group engages in a restructuring after the inversion. The inverted U.S. corporation often attempts to minimize U.S. tax liability by paying deductible amounts of interest, royalties, rents, and management fees to its foreign affiliates, subject to “earnings stripping,” transfer pricing and other applicable limitations.

Post-Inversion Tax Objectives

- Access trapped cash;
- Leverage U.S. corporation to increase U.S. interest tax deductions;
- Transfer assets and activities outside the U.S.;
- Adopt tax-efficient transfer pricing methodology;
- Structure future acquisitions outside the U.S. ownership chain; and
- Decontrol CFCs.

Inversion Tax Cost Prior to Enactment of Section 7874 Anti-Inversion Rules

- In a stock inversion, U.S. shareholders generally recognized taxable gain under Section 367(a) based upon the excess of (i) the fair market value of the shares received over (ii) the adjusted basis of the domestic corporation stock.
 - In many cases, the Section 367(a) “toll charge” was not significant because (i) the shareholders included many tax-exempts and foreign persons or (ii) there was nominal appreciation in value with respect to the underlying stock.
- In an asset inversion, a U.S. corporation generally recognized taxable gain, as if it had sold all of its assets in a taxable transaction.

Section 7874

- The anti-inversion rules of Section 7874 apply if the following three conditions are satisfied:
 - After March 4, 2003, a foreign corporation completes a direct or indirect acquisition of substantially all of the properties of a domestic corporation or partnership;
 - After the acquisition, at least 60% of the stock (by vote or value) of the foreign corporation is owned by former shareholders of the domestic corporation or partners of the domestic partnership (by reason of their holding equity in the domestic entity) (the “Ownership Fraction”); and
 - After the acquisition, the so-called “expanded affiliated group” (the “EAG”) (which includes the foreign acquiring corporation and all entities connected to it by a chain of greater than 50% ownership) does not have “substantial business activities,” as defined below, in the foreign country in which the foreign corporation is incorporated.

“Substantial Business Activities”

- An EAG has “substantial business activities” in a foreign country only if at least 25% of the group employees, group assets, and group income are located or realized in the relevant foreign country. See Regulation Section 1.7874-3.

80-Percent Identity Transactions

- If all of the Section 7874 anti-inversion conditions described above are satisfied and former shareholders of the U.S. corporation hold (by reason of holding stock of the U.S. corporation) 80% or more of the stock of the foreign corporation, the foreign corporation is classified as a U.S. corporation for U.S. tax purposes, and the restructuring is a failed inversion. See Section 7874(a)(2) and (b).

60-80-Percent Identity Transactions

- If former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) at least 60%, but less than 80%, of the stock of the foreign corporation after the acquisition and the other Section 7874 requirements described above are satisfied, the foreign corporation is classified as a “surrogate foreign corporation” that is respected as a foreign corporation for U.S. federal income tax purposes. As a result, all applicable corporate “toll charges” (income or gain required to be recognized under Sections 304, 311, 367, 1001, and 1248) and income or gain recognized in connection with a transfer or license of assets by the U.S. corporation to a related foreign affiliate (so-called “Inversion Gain”) during the 10-year period following the inversion cannot be offset by the U.S. corporation’s tax attributes, such as NOLs and foreign tax credits.

Third Country Rule

- In many inversions, a new holding company (“New Holdco”) acquires stock of the U.S. and foreign target companies. If New Holdco and the foreign target are tax residents of different countries, New Holdco shares issued to the foreign target are not taken into account in determining whether former shareholders of the U.S. target own 80% of the resulting entity. See Temporary Regulation Section 1.7874-9T. This rule does not apply, however, if former shareholders of the U.S. target own less than 60% of the combined entity.
- To avoid a failed inversion, New Holdco and the foreign target must generally be tax residents of the same jurisdiction, unless shareholders of the U.S. target receive less than 60% of the combined entity or the “substantial business activity” test is satisfied.

Planning to Avoid an Inversion

- Increasing the size of the foreign acquiring corporation or reducing the size of the U.S. target lessens the risk that the acquisition would be classified as an inversion. Anti-avoidance rules include:
 - Multiple Domestic Acquisition Rule;
 - Passive Assets Rule; and
 - Non-Ordinary Course Distributions (“NOCDs”) Rule.

Multiple Domestic Acquisition Rule

- Stock of the foreign acquiring corporation is disregarded for purposes of determining the Ownership Fraction to the extent the stock is attributable to the value of previous domestic acquisitions that occurred within three years of the signing date of the new U.S. entity acquisition. See Temporary Regulation Section 1.7874-8T.

Passive Assets Rule

- If and to the extent that more than 50% of the assets of the foreign acquiring corporation are “non-qualified property” (liquid assets such as cash, marketable securities, and intercompany obligations), a portion of the stock of the foreign acquiring corporation is excluded from the Ownership Fraction, thus increasing the risk that the transaction would be classified as an inversion. See Temporary Regulation Section 1.7874-7T.

Non-Ordinary Course Distributions (“NOCDs”) Rule

- All distributions made by the U.S. corporation or its predecessor during the three consecutive 12-month periods prior to the acquisition in excess of 110% of the average annual distributions during the three-year period preceding the acquisition are classified as NOCDs, and are excluded from the numerator and the denominator in computing the Ownership Fraction. See Temporary Regulation Section 1.7874-10T.

Post-Inversion Limitations

“Hopscotch” Loan

- Cash held by a CFC cannot be loaned to its U.S. parent without triggering U.S. tax under Section 956, subject to limited exceptions.
- Prior to the issuance of IRS Notice 2014-52, cash held by a CFC of an inverted corporation could have been loaned to the ultimate foreign parent or to a foreign affiliate without giving rise to tax under Section 956.
- Pursuant to IRS Notice 2014-52 and Temporary Regulation Section 1.956-2T(a)(4), during the 10-year period following an inversion, any loan made by a CFC of an inverted corporation directly to the new foreign parent (a so-called “hopscotch” loan) or to a related foreign affiliate is subject to Section 956 and generally triggers U.S. tax.

New “Debt-Equity” Regulations

- Under recent “debt-equity” regulations, a purported debt instrument issued by a U.S. subsidiary to its foreign parent in connection with a corporate distribution is generally classified as equity for U.S. tax purposes. See Regulation Section 1.385-3. This regulation was promulgated, in part, to eliminate the ability of a U.S. corporation to distribute a note to its foreign parent following an inversion in order to create U.S. interest deductions.

Inversion Excise Tax

- Section 4985 imposes a 15% excise tax on so-called “specified stock compensation” (“SSC”) realized by certain officers and directors of an inverted corporation. SSC reflects almost all types of equity-based compensation.
 - The excise tax is imposed if, after a restructuring, shareholders of an inverted corporation own 60% or more, but less than 80%, of the acquiring foreign corporation.
 - In most cases, the inverted corporation pays the excise tax on behalf of the individual.
 - Any payment of the excise tax by the inverted corporation triggers taxable income to the individual and additional excise tax.

Trap for Unwary

Assume the following facts:

- A nonresident alien individual (“NRA”) organizes a U.S. corporation to acquire U.S. real estate.
- NRA later realizes that he could potentially be subject to U.S. estate tax.
- To avoid U.S. estate tax, NRA transfers stock of the U.S. corporation to a foreign holding company.

Query: Would the foreign holding company be classified as a U.S. corporation for U.S. tax purposes under the anti-inversion rules?

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