Extensive New Anti-Inversion Rules Issued

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Blanchard summarizes the provisions of anti-inversion guidance Notice 2014-52 and suggests some practical tips for what it might mean in the future.

On September 23 the IRS released Notice 2014-52, its latest — and feverishly anticipated — package of anti-inversion rules. Those rules were rushed out in response to growing political insistence that something had to be done to stop the so-called tsunami of inversions supposedly taking place in recent months. Given the political deadlock in Congress, the executive and legislative branches appeared to be largely in agreement that for the time being, it was up to the IRS to take action — so it did.

The range of new initiatives in the notice is impressive, encompassing three new rules intended to sweep more transactions into the punitive anti-inversion net of section 7874 and three new rules targeting post-inversion planning (PIP). As for the first set of rules, the IRS lacks the authority to change the ownership fraction of 80 percent required to treat the foreign acquirer as a domestic corporation. However, it continued its pattern of stretching its regulatory authority to the limit — some would say beyond the limit — to reach as many transactions as possible by adopting rules to minimize the denominator and maximize the numerator of the ownership fraction, goosing the fraction upward.

All six new rules are effective for acquisitions and other relevant transfers completed on or after September 22. None of the rules affects closed deals.

However, the notice purports to affect deals that have been signed but not closed; it contains no binding contract exception. And, of course, the notice contains the obligatory disclaimer that nothing therein should be construed as suggesting that the IRS cannot attack older transactions under existing law.

The notice requests comments concerning how the IRS might implement an income-stripping rule, and warns that any rule that by its terms is limited to inversions will also apply to deals completed on or after September 22. That warning was clearly intended to deter inverters from engaging in income stripping even though no new rule addresses that technique.

This article assumes that the reader is somewhat familiar with section 7874 and the basic tax rules that apply to inversions. The domestic combining entity (the U.S. target) will be referred to as DE, the foreign acquirer as FA, and the expanded affiliated group of which they are both members as the EAG. For the uninitiated, the notice does a good job giving the background, most of which will not be repeated here.

A. Casting a Wider Net

Notice 2014-52 contains three new definitional rules intended to capture more transactions under the 80 percent test of section 7874(b), with the intended result being that FA is treated as a domestic corporation. In general, the rules operate by manipulating the calculation of the ownership fraction, excluding some FA stock issued to persons other than shareholders of DE from the denominator and increasing the number of shares held “by reason of” owning an interest in DE that are included in the numerator.

1. The cash box foreign entity. Regulations issued under section 7874 earlier this year hinted that the IRS wanted to exclude FA stock from the denominator when issued to shareholders of a foreign combining entity that was principally a “cash box.” The concern may be over inversions such as Perrigo Co.’s acquisitions of Elan Corp., an Irish drugmaker that had sold most of its patents and was collecting royalties.

Assuming that a threshold test is met as described below, the notice provides that a portion of FA stock issued to persons other than DE’s shareholders (and other than FA stock already excluded
under another regulation), corresponding to the proportion of foreign group assets that are treated as nonqualified property, is excluded from the denominator of the ownership fraction. The consequent increase of the fraction makes it more likely that an inversion will occur.

Nonqualified property is everything described as such in reg. section 1.7874-4T(i)(7), including, importantly, cash. There is an exclusion for property used in a banking, financing, or insurance business described in section 954(h), 954(i), or 1297(b)(2)(A). An antiabuse rule disregards qualified property issued in exchange for nonqualified property.

The new rule applies only if more than 50 percent of the gross value of the properties of the foreign group members consists of nonqualified property. In making the threshold calculation, the denominator consists of all property of the foreign members of the EAG other than property owned by domestic members or their subsidiaries and other than intercompany obligations and stock.

The authority to adopt that rule is murky at best, and it is difficult to articulate a policy for it. The notice attempts to justify its authority by reference to a provision in section 7874 authorizing the IRS to not treat stock as stock, but why that authority would permit it to ignore stock based on the type of assets a corporation holds is certainly not obvious. Although a tax-free reorganization requires a non-tax business purpose, nothing in section 7874 does so. Moreover, the IRS has repeatedly rejected any role for business purpose under section 7874.

Practical effect of the cash box rule: It will be necessary to consider and assign a value to the assets of the foreign combining entity to determine whether the ownership fraction is increased by reason of its holding too many nonqualified assets.

2. No more 'skinnying down.' Regulations under section 367(a) have long included a substantiality test under which it is required, as a condition to nonrecognition of gain by U.S. shareholders in an outbound reorganization, that the foreign combining entity be “larger” than the U.S. one. Those regulations contain detailed anti-stuffing rules applicable to the foreign transferee corporation. However, nothing prevents the domestic transferor from declaring a pre-merger distribution to its shareholders, thereby skinnying down to become smaller than its foreign counterpart. The skinny-down technique has been used in some recent transactions labeled as inversions in the popular press. However, it appears that at least some of those transactions would not have been inversions in any case and that the skinnying down was done for traditional section 367(a) reasons (to avoid U.S. shareholder gain recognition).

For both section 367(a) and section 7874, the notice disregards non-ordinary course distributions (as defined below) made during the 36-month period preceding the inversion. The effect of disregarding those distributions will be that the percentage of FA stock treated as owned by historic shareholders of DE — the numerator of the ownership fraction — will not be reduced by non-ordinary course distributions. Although the mechanics of applying the new rule for purposes of the section 367(a) substantiality test are fairly clear, it is not as clear how the rule will be applied for purposes of section 7874. Presumably the IRS intends to treat the amount of the distribution as if it had been made in exchange for stock of equal value, and will then add back those shares into the numerator and the denominator of the ownership fraction.

The notice defines a non-ordinary course distribution as any distribution that exceeds 110 percent of the average annual amount of distributions made by the DE over the prior 36 months. Distributions caught by the rule are not limited to dividends and can include distributions under a section 355 spinoff as well as distributions made in connection with other tax-free reorganizations.

The 110 percent averaging rule is particularly inapt as applied to DEs that are partnerships, and it should be removed in that context. Partners of partnerships are taxable on partnership income whether or not any distributions are made; when a partnership makes a distribution, it is not a taxable event to the extent of a partner’s basis that includes income inclusions. Many operating partnerships make what are known as “tax distributions” to their partners, which are simply distributions of enough cash to pay taxes on partnership income. Those minimum distributions (which may be the only distributions normally made, as cash is retained to grow the business) will be a function of the profitability of the partnership and are analogous to the taxes a corporation pays. Thus, they should not be thought of as “distributions” at all for these purposes. If the partnership suffers a couple of years of losses or low profitability, its distributions are likely to be small or zero. If a flush year follows, distributions are likely to be large enough to pay taxes owing for that flush year. That type of distribution could run afoul of the bright-line 110 percent rule even though it does not function in any way like a
corporate distribution, which is made after corporate taxes are paid at the corporate level.

**Practical effect of the anti-skinny-down rule:** In any cross-border deal it will now become necessary to reconstruct all non-ordinary course distributions undertaken over the previous 36 months. The rule could result in transactions being treated as inversions even though nothing of the kind is occurring. Also, the impact of that rule on traditional section 367(a) planning will be significant. U.S. shareholders of U.S. targets in cross-border mergers will be more likely to have to recognize gain, given the inability to skinny down the U.S. corporation. The rule is not based on any discernable policy concern and will be very difficult to monitor and enforce; it should be redrafted as a narrower antiabuse rule.

3. **Subsequent transfers of FA shares.** The notice observed that two existing rules under section 7874 can be combined to produce what the IRS considers to be an inappropriate result. The first of those rules, which had been intended to be punitive, is the “frozen numerator” rule of reg. section 1.7874-5T. It provides simply that stock of FA owned “by reason of” owning DE stock does not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder or partner of DE, even if the subsequent transfer is related to the acquisition.

The second set of rules outlined in the notice are two exceptions from the EAG rule found at reg. section 1.7874-1(c)(2) and -1(c)(3). Those protaxpayer rules are necessary to avoid the absurd results that would be obtained if section 7874’s mathematical rules were applied when stock is held in an EAG. But taken together with the frozen numerator rule, a corporate shareholder of DE could transfer FA shares, received by reason of being a shareholder of DE, to a third party who is not a member of the EAG, without losing the benefit of the EAG exceptions. The apparent target of the new rule is the case in which a U.S. parent corporation drops stock of a domestic subsidiary into a new foreign subsidiary and then distributes the stock of the foreign subsidiary to its shareholders, often in a transaction intended to qualify as a tax-free spinoff.

Section 2.03(b) of the notice seeks to forestall that possibility by turning off the EAG exceptions and counting the transferred shares in both the numerator and the denominator of the ownership fraction. That happens, however, only when the subsequent transfer by the corporate shareholder is related to the acquisition. Because it may be unclear in many cases when a subsequent transfer is related to an acquisition, most taxpayers will assume the worst.

There are two exceptions to that treatment, both of which apply to transfers among members of an EAG. In the case of a foreign-parented EAG, a subsequent transfer of FA stock will generally be excused if DE had already been a member of the group and ceases to be so only by reason of the distribution. The notice gives an example of a foreign parent that drops the stock of DE into a foreign acquiring corporation for stock of the latter, and then spins off the stock of the foreign acquirer to its shareholders. In the case of a U.S.-parented EAG, transfers are permitted only among domestic members of the EAG. The exceptions make sense, given that the purpose of the new rule is not implicated when the subsequent transfer of the FA shares is to a person who could have received those shares originally.

Although the distribution rule, like the others, purports to apply to inversions completed on and after September 22, taxpayers are permitted to elect into it for previous periods. A taxpayer might wish to do so to obtain certainty that the exceptions described immediately above will apply to forestall any challenge to its reliance on an EAG exception under prior law.

**Practical effect of the subsequent transfer rule:** This rule is unlikely to have much impact because most of the transactions it targets would be taxable under section 367, and thus unlikely to be undertaken except in cases in which there is little or no gain on the transferred DE. Nevertheless, corporate shareholders of DE may be asked to sign representations that they have no plan or intention of disposing of their FA shares following an acquisition. Readers who recall the days when the continuity of proprietary interest test still applied will have fond memories of negotiating those representations!

B. **Post-Inversion Planning Rules**

It is commonly thought that many inversions are done to enable post-inversion planning by the inverted U.S. company. That planning would typically seek to reduce U.S. tax by creating new deductible expenses in the U.S. group and by minimizing the U.S. tax cost of repatriating earnings and profits from controlled foreign corporations. The notice contains three new rules intended to discourage PIP: (1) an anti-hopscotch rule under section 956; (2) a rule designed to discourage decontrolling CFCs; and (3) a rule for the application of section 304(b)(5)(B).

Before describing those three rules, it is important to note what the notice did not include. There is no rule cracking down on interest-stripping or similar income-stripping transactions. However, the notice warns that if the IRS can figure out that it has colorable authority to write those rules, and they can be applied only to inversions, they would be retroactive to September 22. The *in terrorem* effect of
that warning is probably enough to give many would-be strippers pause.

The notice does not limit the ability of inverted groups to cause DE’s historic CFCs to sell assets to FA or an FA affiliate. That technique may be used to “freeze” and defer ongoing exposure to subpart F without giving rise to immediate subpart F income. (Henceforth, the CFC will earn subpart F income each year as an investment return accrues on the cash proceeds of the sale.) Nor did the notice even mention the practice referred to as “business restructuring,” which basically involves stripping risk out of the United States and other high-tax jurisdictions and implicates the notoriously subjective transfer pricing rules. Many observers believe it is that practice, more than anything else, that erodes the U.S. corporate tax base.

1. The anti-hopscotch rule. This is the easiest rule in the notice to understand, although it may be tricky to apply in practice. This rule will treat as an investment in U.S. property the amount of any investment by a DE CFC in the stock or debt of a foreign member of the EAG (other than another historic DE CFC). Section 956 will apply only to investments made during the 10-year applicable period of section 7874(d)(1).

The notice makes clear that the usual pledge and guarantee rules of section 956(d) apply. Thus, if a DE CFC guarantees the debt of FA or another foreign affiliate of FA, section 956 will apply.

Note that the provision is effective for investments made on or after September 22, but only if an inversion was completed on or after that date. Thus, if the inversion were completed before September 22, a later investment described in that portion of the notice would not be affected.

Practical effect of the anti-hopscotch rule: Under the notice, inverted companies will not be able to access the untaxed E&P of DE CFCs by causing those CFCs to make loans or share purchases around DE. Section 956 will apply even to a loan that is made for business reasons, even if it is repaid in due course in accordance with its terms.

2. Decontrolling CFCs. This set of rules, in section 3.02 of the notice, is by far the most complex set of rules in the notice. Here the IRS is attempting to combine different grants of authority — specifically sections 7701(l) and 367(b) — to justify a truly novel approach to ending deferral. Some background is required.

If DE were simply to transfer shares of a CFC to FA or another foreign member of the post-inversion EAG in a taxable transaction, DE would be required to pay tax on its gain, and a portion of its gain equal to the untaxed E&P of the CFC would be treated as dividend income under section 1248. If the transfer were made as part of a tax-free reorganization, and if by reason of the transfer the CFC then ceased to be a CFC, section 367(b) would similarly require DE to pick up the untaxed E&P of the transferred CFC.4

But if FA simply contributes property (which might be stock of the foreign combining party in the inversion) to the CFC for CFC shares, generally neither section 1248 nor section 367(b) would apply. DE’s ownership of the CFC will be diluted, with the result that its share of the CFC’s untaxed E&P will also be diluted. The CFC may even cease to be a CFC if the investment is large enough. (Those results are in part attributable to the fact that subpart F, unlike many other provisions of the code, does not apply on a closing-of-the-books basis, but rather on a per diem basis.) The notice refers to investments that dilute DE’s interest in a CFC as “specified transactions.” Specified transactions include any transaction, including a sale, in which stock of a DE CFC is transferred to a newly related foreign affiliate.

The notice provides that if there is a “specified transaction” during the 10-year applicable period, the specified transaction will be recast as a pair of back-to-back transactions under the authority of section 7701(l). That is, the simple transfer of property by FA to a CFC of DE will be treated as if: (1) FA first transferred the property to DE and then (2) DE transferred the same property to the CFC. In the first transfer, DE is deemed to issue instruments identical to those actually issued by the CFC. In that way, when the CFC makes a payment on the actual investment, it will be treated as if the CFC made the payment to DE, not FA, and as if DE made a corresponding payment to FA. Among other results, DE could recognize income, and U.S. withholding tax could apply to the deemed payment by DE to FA.

The notice also provides that if, as a result of a specified transaction, a CFC of DE is considered to receive a dividend by reason of section 964(e), the dividend will not qualify for any exclusion from subpart F income such as that provided under section 954(c)(6) and Notice 2007-9.5 Thus, for example, if CFC1 were to sell stock of CFC2 to a foreign affiliate, any deemed dividend arising from the sale would be subpart F income to DE.

Finally, the notice announced that the section 367(b) regulations will be amended to require a U.S. shareholder to include in income the untaxed E&P of a CFC in the case of any specified exchange, regardless of whether the transferred CFC ceases to

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4Reg. section 1.367(b)-4(b). The same rule would apply to some preferred stock freezes or recapitalizations that achieve similar results.
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be a CFC. A specified exchange is an exchange in which a shareholder of a CFC exchanges its stock for stock of another foreign corporation in any transaction described in reg. section 1.367(b)-4(a) (generally any nonrecognition transaction). That is a fundamental change to the manner in which section 367(b) has traditionally applied. When the rule applies, the foregoing recast rule will not apply, since the untaxed E&P of the subject CFC will have already been taken into account by DE.

Like the anti-hopscotch rule, the rule is stated to apply to specified transactions and exchanges done on or after September 22, but only if an inversion was done on or after that date.

**Practical effects of the decontrol rules:** These rules look fairly certain to put an end to any techniques for decontrolling CFCs without paying tax on their untaxed E&P. Some taxpayers will undertake those transactions anyway, to put future foreign income outside the U.S. tax net, especially if the current hit is not too large. Moreover, if the CFC in question has paid foreign taxes, those taxes would generally be creditable against the amount taken into account for U.S. tax purposes. (That assumes that the notice’s decontrol rules do not create “inversion gain” within the meaning of section 7874(d)(2), in which case the inversion gain would be treated as having a U.S. source for foreign tax credit purposes under section 7874(e)(1)).

3. **Section 304.** Section 304(b)(5)(B) provides:

   In the case of any acquisition to which [section 304(a)] applies in which the acquiring corporation is a foreign corporation, no earnings and profits shall be taken into account under paragraph (2)(A) (and subparagraph (A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to this subparagraph) would neither — (i) be subject to tax under this chapter for the taxable year in which the dividends arise, nor (ii) be includible in the earnings and profits of a controlled foreign corporation.

   The purpose of that provision is to prevent taxpayers from stripping out E&P from a foreign acquiring corporation to a selling foreign person without going through a U.S. corporate taxpayer.

   The notice expressed a concern that FA might sell some shares of DE to a CFC of DE in exchange for assets of the CFC in a section 304(a)(2) transaction following an inversion. (It is worth noting that if that is all that happens, the CFC would have an investment in U.S. property within the meaning of section 956.) Although that provision became effective on enactment in 1999, the notice appears to reflect a concern that taxpayers may be taking the position that it does not apply when more than 50 percent of the deemed dividend is sourced from a U.S. corporation in a section 304(a)(2) situation, even when that dividend would not be taxed by reason of a treaty. If the provision did not apply, E&P of the CFC could be permanently repatriated free of U.S. tax.

   The notice provides that in determining whether more than 50 percent of the dividends arising from the acquisition are subject to tax, only the E&P of the acquiring corporation will be taken into account. That rule will apply generally — it is not limited to inversions.

   **Practical effect of the section 304 rule:** Very little. This looks to be a rule that the IRS just threw into the mix to make the anti-inversion package look heftier.

C. **Conclusions**

   Although one must admire the IRS and Treasury in their dedication to doing what is administratively possible to discourage what they evidently believe to be inversions contravening public policy, it is likely that in practice those measures will accomplish very little — other than to bedevil taxpayers trying to structure real mergers that should have never been targeted by the rules in the first place. In the end, the most important reason to invert is to make future acquisitions and to effect future growth outside the U.S. tax net. That cannot be addressed by PIP rules. Fundamental tax reform — if it could align the U.S. corporate tax rules more closely with those in other countries — is the only sure way to dampen the enthusiasm for inversions. In the meantime, U.S. companies are targets for real, cash acquisitions by non-U.S. companies, which is much more likely to cause the loss of U.S. jobs than any inversion possibly could.