ANTI-INVERSION RULES EXPANDED

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INTRODUCTION

The latest step in inversion controversy involving U.S. publicly traded corporations is the upcoming merger between pharmaceutical giants, Pfizer and Allergen, in a stock transaction estimated to be worth $160 billion.

The merger is structured as an inversion, in which a U.S. company (Pfizer) combines with a non-U.S. company (Allergen) headquartered in another country. More than 50 similar transactions have been completed over the last three decades, involving companies such as Medtronic, Fruit of the Loom, and Ingersoll Rand. Congressional researchers have estimated that inversions will cost the U.S. treasury $20 billion in the next ten years.

The U.S. Treasury department recently announced that new rules will be issued to limit the attraction of an inversion.

BACKGROUND

The acquisition of a U.S. corporation or its properties is an inversion if three conditions are met.

- The foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by a domestic corporation;
- After the acquisition, at least 60% of the stock of the foreign acquiring corporation, measured by vote or value, is held by former shareholders of the domestic corporation by reason of having been shareholders of the domestic corporation; and
- After the acquisition, the expanded affiliated group that includes the foreign acquiring corporation ("E.A.G.") does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized; this occurs when less than 25% of the business activity of the E.A.G. are in the home country of the foreign acquiring corporation.

If the U.S. shareholders own 80% or more of the new foreign parent, again measured by vote or value, the foreign acquisition corporation is treated as a U.S. corporation. If, instead, the ownership percentage is at least 60% but less than 80%, the foreign acquiring corporation is respected as a foreign corporation, but the domestic entity and certain related U.S. persons based on 50% ownership are treated as expatriated entities. These entities must recognize income or gain realized from the transfer of stock or other properties in the transaction. They also must recognize income from certain transactions and licenses for a period of ten years without the opportunity to reduce tax by credits, expenses paid to related foreign persons, or net operating loss carryovers.

GUIDANCE

The I.R.S. has identified several planning opportunities that it believes is abusive because they prevent application of the anti-inversion rules. In Notice 2015-79, the I.R.S. outlined forthcoming guidance on corporate inversions in response to the identified abuses. The abusive plans and the I.R.S. responses include the following:

- *Manipulating Substantial Activity Rules*: The I.R.S. is aware of transactions in which a taxpayer asserts that the E.A.G. has substantial business activities in the relevant foreign country, but the foreign acquiring corporation is not subject to income taxation in the relevant foreign country as a resident. According to the I.R.S., this is abusive. Accordingly, the Treasury Department and the I.R.S. intends to issue regulations under Code §7874 to provide that an E.A.G. cannot have substantial business activities in a foreign country unless the foreign acquiring corporation is subject to tax as a resident of the that country.

- *Third Country Transactions*: The I.R.S. is aware that certain acquisitions in which a domestic entity combines with an existing foreign corporation are structured by establishing a new foreign parent corporation with a tax residence that is different from that of the existing foreign corporation. In these transactions, the stock or assets of the existing foreign corporation are acquired by the new third-country parent and the U.S. shareholder group own less than 80% of the parent in the third country. The I.R.S. is concerned that a decision to locate the tax residence of a new foreign parent corporation outside of both the United States and the jurisdiction in which the existing foreign corporation is tax resident generally is driven by abusive tax planning. This may include choosing a country with a more favorable tax system or a more favorable treaty with the U.S. This allows a third-country parent to use low-tax or no-tax entities to erode the U.S. tax base following the acquisition. Accordingly, regulations will be issued to disregard certain stock of a foreign acquiring corporation that is issued to the shareholders of the existing foreign corporation for purposes of determining whether the 80% threshold is met.

  The regulations will apply to an acquisition that satisfies four requirements:

  - The foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation;
  - The gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign target acquisition exceeds 60% of the gross value of all foreign group property computed by ignoring excluded property;
  - The tax residence of the foreign acquiring corporation is not the same as that of the foreign target corporation, immediately before the transaction; and
  - The ownership percentage maintained by the U.S. shareholder group is at least 60% but less than 80%.

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- *Disregard of Stock Transferred in Exchange for Nonqualified Property*: Stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition is excluded from the denominator of the ownership fraction. Disqualified stock includes stock of the foreign acquiring corporation that is transferred in exchange for "nonqualified property." Nonqualified property includes (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations, and (iv) any other property acquired with a principal purpose of avoiding the anti-inversion rules. The I.R.S. is concerned that some taxpayers are narrowly interpreting the definition of avoidance property, contending that it is limited to stock that is used to transfer indirectly specified nonqualified property to the foreign acquiring corporation. Accordingly, the I.R.S. will issue regulations to provide that avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of Code §7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property.

- *Post-Acquisition Transactions*: The I.R.S. is concerned that certain indirect transfers of stock or other property by an expatriated entity rather than direct transfers by the expatriated entity itself have the effect of removing foreign operations from U.S. taxing jurisdiction because under current law the income is not inversion gain. Consequently, attributes can be used to reduce the tax. Accordingly, the I.R.S. will issue regulations providing that inversion gains include income or gain recognized by an expatriated entity from an indirect transfer or license of property if the transfer or license is to a specified related person.

- *Code §1248 Toll Charges*: Current §367(b) regulations require a shareholder that exchanges stock in a transaction resulting in a loss of C.F.C. status to include in its income as a deemed dividend the Code §1248 amount when the exchange results in a loss of future exposure under Code §1248. The I.R.S. is concerned that the toll charge is not a sufficient deterrent. Accordingly, the I.R.S. will amend the regulations so that the exchanging shareholder will also recognize all realized gain with respect to the exchanged stock.

Notice 2015-79 also revises certain provisions previously addressed in Notice 2014-52.

Subject to certain exceptions, Notice 2015-79 is generally effective on or after November 19, 2015, but only if the inversion transaction is completed on or after September 22, 2014, the date on which Notice 2014-52 was issued.