# ANTI-INVERSION RULES ARE NOT JUST FOR MEGA-MERGERS – PRIVATE CLIENT ADVISORS TAKE NOTE

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**Tags**
Corporate Tax
Cross-Border Tax Planning
Expatriation
Inversions
Private Client
Tax Planning

## INTRODUCTION

Transactions known as corporate "inversions" or "expatriations" have made headlines for years. Recently, the proposed merger of the U.S. pharmaceutical giant Pfizer, Inc. with the Irish-based pharmaceutical company Allergan Plc was in the news. The coverage addressed the implications of creating the world's largest pharmaceutical company, the loss of yet another American corporate behemoth to a lower-tax jurisdiction, and later, the plan's cancellation, arguably as a result of the U.S. government's regulatory action.

As laws limiting tax-free inversions have developed, tax attorneys specializing in corporate mergers and acquisitions have been required to keep up with regulatory developments and consider new planning techniques – but they are not the only ones with such obligations. Tax attorneys advising individuals and families who own closely-held businesses, investment structures, and even personal use property, with cross-border aspects, must also keep the inversion rules on the forefront of tax planning. In the private client setting, inversions are sometimes overlooked, perhaps because the issue is so closely associated with large "M&A" deals.

The following article examines how the inversion rules can affect cross-border tax planning for individuals. It begins with a brief discussion on the development of the inversion rules over time and some of the planning techniques that have been used to address the legislative and regulatory changes.

## U.S. CORPORATE INCOME TAX SYSTEM

To understand the impetus for inversions, it is important to have a basic understanding of the U.S. corporate income tax system.

Corporations that are formed under U.S. domestic law are U.S. persons. Like all U.S. persons, U.S. corporations are subject to U.S. income tax on their worldwide income. Accordingly, when a U.S. corporation earns income from sources outside the U.S., that income is subject to U.S. income tax, though not necessarily on a current basis. A U.S. corporation can defer income tax on active income (*i.e.*, income earned by operating a trade or business) earned outside the U.S. through foreign subsidiaries until it is paid or repatriated to the U.S. parent corporation. If a foreign subsidiary earns certain foreign-source income from passive-type investments (*e.g.*, interest, dividends, rents, royalties), its U.S. parent corporation may be required to pay tax on that income – referred to as Subpart F income – in the tax year it is earned, regardless of whether the foreign subsidiary makes a dividend distribution to the U.S. parent corporation.

For financial statement purposes, the profit and loss statement generally does not

follow the Subpart F rules. Whether U.S. tax is deferred or imposed currently on the tax return of a U.S.-based multinational, U.S. tax expense must be recorded when and as income of foreign subsidiaries is reported on the U.S.-based group's consolidated financial statements prepared in accordance with U.S. G.A.A.P. The principal exception to this accounting treatment exists when the earnings of foreign subsidiaries are permanently invested abroad.

For a U.S.-based multinational, the true benefit of an inversion is the release of earnings that were permanently invested abroad for financial statement purposes. Those earnings can then be distributed to the new parent company, used internally within the group, or distributed to shareholders without affecting the reported earnings of the company.

## WHAT IS A CORPORATE INVERSION?

In simplest terms, a corporate inversion is a process by which an existing U.S. corporation changes its legal domicile to a lower-tax jurisdiction. The inversion transaction involves a reorganization of a corporate structure that results in a foreign parent corporation at the top of the corporate structure, where there was previously a U.S. corporation. The original U.S. parent corporation becomes a subsidiary of a new or existing foreign corporation; at which point, the corporate structure is said to be "inverted."

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The foreign parent corporation used in the inversion will be resident in a low-tax jurisdiction,[1] where foreign-source income is not subject to local tax or where dividends from foreign subsidiaries are not subject to income tax at the level of the new foreign parent and dividends from the parent are not subject to dividend withholding tax. The key is that dividends from low-taxed foreign subsidiaries do not trigger tax upon receipt and that the foregoing tax benefit is not reduced by withholding tax on dividends to shareholders. Because the foreign subsidiary operates in a low-tax environment, a tax system that does not provide an exemption, but instead allows an indirect credit for foreign taxes imposed on the subsidiary, is not attractive.

Corporate inversions have been achieved using one of three of the following plans:

- A merger with a larger foreign corporation, resulting in a new company controlled outside the U.S.
- A merger with a smaller foreign corporation, resulting in a new company controlled by the shareholders of the original U.S. corporation
- The formation of a foreign subsidiary in a jurisdiction in which the U.S. corporation has substantial business activities, followed by a "B reorganization" (*i.e.*, a stock-for-stock exchange creating a new structure in which the foreign corporation is the parent and the U.S. corporation is its subsidiary), and resulting in no change in effective control

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[1] In the more aggressive corporate inversions of the past, the foreign parent corporation typically was formed in a jurisdiction that did not impose any corporate income tax. However, the important keys for choosing a jurisdiction are benign controlled foreign corporation rules, a participation exemption for the receipt of intercompany dividends and the realization of gains from the disposition of shares in a subsidiary, and the absence of withholding tax on dividend payments.

Prior to the enactment of the anti-inversion rules, a U.S. corporation generally was able to eliminate or reduce its U.S. income tax obligation as a result of inversion in the following ways:

- Moving its foreign business operations to foreign subsidiaries owned by the foreign parent corporation, thereby removing its foreign-source business income from its tax base
- Allowing the accumulated or future income in its foreign subsidiaries to be accessed by group members in the U.S. through loans that do not trigger tax under Subpart F
- Making accumulated or future income available as a funding source for dividends to shareholders
- Engaging in "earnings stripping" through intercompany debt, royalty payments, management fees, and other arrangements (*e.g.*, the foreign parent corporation may lend to its U.S. subsidiary – this creates an interest expense deduction for the U.S. subsidiary, which lowers its U.S. taxable income)

As discussed below, Congressional action has created substantial barriers for inversion transactions, and regulatory action has closed loopholes and curbed some tax benefits.

## LEGISLATIVE AND REGULATORY RESPONSE TO CORPORATE INVERSIONS

### Code §367(a)

The earliest legislative response to corporate inversions was the enactment of Code §367(a), which generally applies to U.S. persons (including individuals and corporations) that transfer appreciated property to a foreign corporation. Transactions targeted by Code §367(a) involve outbound transfers of appreciated property through a nonrecognition transaction, such as a capital contribution to a controlled corporation or tax-free outbound reorganization. Under Code §367(a), the appreciation in property is recognized and generally taxed by the U.S. at the time of transfer to a person that is beyond the scope of U.S. tax jurisdiction. Appreciated property subject to Code §367(a) includes stock in another corporation.

Code §367(a) targets such transactions by effectively denying tax-free treatment to what is otherwise a nonrecognition transaction. It does this by treating the transfer as if the consideration received is other than shares of stock. This treatment eliminates deferral opportunities since most deferral transactions involve a transfer of property – including shares of stock in a corporation – for shares of stock in an acquiring corporation.

### Code §7874

Despite these efforts, Code §367(a) did not prove to be a sufficient deterrent to corporate inversions. Some U.S. corporations calculated that the upfront tax cost of Code §367(a) was worth the benefit of removing or deferring income from the reach of relatively high U.S. Federal corporate income tax (currently, the rates are 34% and 35%). In some cases, there may have been no upfront tax cost because the

U.S. corporation's stock did not appreciate during the holding period or because the shareholder group was comprised to a large extent by entities that are tax exempt in the U.S. (*e.g.*, pension funds, not-for-profit organizations, and foreign investors).

Code §7874 was enacted in 2004 to remedy the absence of an effective disincentive to inversions. For its part, the Treasury Department subsequently issued regulations to close certain loopholes found by tax planners under Code §7874. The most comprehensive Treasury Regulations were issued in 2012 and 2016.

In broad terms, Code §7874 either causes the inversion transaction to be ignored – so that the inverted corporation continues to be treated as a U.S. corporation for U.S. tax purposes – or respects the inversion transaction but subjects the transaction to unfavorable tax treatment for ten years. As discussed in detail below, whether an inversion transaction is ignored or respected depends upon the level of ownership continuity.

Code §7874 applies to "expatriated entities" and their "surrogate foreign corporations." A surrogate foreign corporation is a foreign corporation that, pursuant to a plan or a series of related transactions, meets the following benchmarks:

- It directly or indirectly acquired substantially all of the properties constituting a trade or business of a domestic corporation or a domestic partnership.
- After such acquisition, at least 60% of its stock (by vote or value) is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation or, in the case of a partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership.
- Neither it nor its expanded affiliated group (*i.e.*, the group that now includes the U.S. corporation) have substantial business activities in the foreign country in which the foreign corporation is created or organized, after the acquisition described in the first bullet, when compared to the total business activities of the expanded affiliated group.[2]

An expatriated entity is a domestic corporation or domestic partnership with respect to which a foreign corporation is a surrogate foreign corporation and includes any domestic corporation or domestic partnership related to the expatriated entity.[3]

The inversion is ignored, and the foreign corporation is treated as a domestic corporation for all purposes of the Code if, after the transaction, the former shareholders of the domestic corporation or, in the case of a partnership, the former partners of the domestic partnership own 80% or more of the surrogate foreign corporation, measured by vote or value, and the substantial business activities test is not met.[4]

If (i) ownership continuity is at least 60% but not as much as 80% and (ii) the substantial business activities test is not met, the expatriated entity will be subject to U.S. income tax on its "inversion gain" for a defined period.[5] Inversion gain means

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[2] Code §7874(a)(2)(B).

[3] Code §7874(a)(2)(A).

[4] Code §7874(b).

[5] Code §7874(a)(1).

income or gain recognized by reason of the transfer of stock or other properties in the inversion transaction.[6] It also includes certain income from the licensing of property by the expatriated entity during the defined period.[7] The defined period is lengthy: It starts on the first date that properties are acquired as part of the inversion transaction and ends ten years after the last date.[8]

A number of other unfavorable tax provisions apply to the inversion gain. For example, the use of credits to offset the tax on the inversion gain is limited; net operating losses generally may not be used to offset the amount of inversion gain that is taxed; and inversion gain is considered U.S.-source income for the purpose of computing the foreign tax credit.[9]

Code §7874(c)(4) is an anti-abuse rule that disregards transactions designed to manage the value of a corporation involved in a potential inversion. Thus, the transfer of properties to enhance the value of a foreign corporation or the undertaking of liabilities to reduce the value of the U.S. corporation will be ignored when the transaction is part of a plan designed principally to avoid Code §7874. This rule would apply, for example, to the transfer of assets to a foreign corporation before the inversion transaction so that the value of the foreign corporation is increased in order to prevent the value of the U.S. corporation from breaching the 60% threshold.

## Regulatory Action

Since the enactment of Code §7874, several notices and regulations have been issued, primarily to narrow the opportunities in which a transaction avoids being characterized as an inversion transaction. The rules are extensive and complicated. The following is a brief discussion of several of the more important rules.

Temporary and proposed regulations[10] issued in 2012 and recently finalized[11] include a safe harbor for the substantial business activities test that is considerably more difficult to meet than a predecessor under prior regulations. Under the rule, an expanded affiliated group will be considered to have substantial business activities in a foreign country if at least 25% of the group's employees, assets, and income are located in or derived from that country.[12] This generally means that an employee or asset must be physically present in the country in order to be located there. Income will be considered as derived in a foreign country only if customers are located in the country. Under prior regulations, the safe harbor was set at 10%. The increased safe harbor makes it considerably more difficult for transactions that meet the 60%

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6 Code §7874(d)(2).

7 *Id.*

8 Code §7874(d)(1).

9 Code §§7874(e)(1) and (3).

10 Temporary regulations generally provide guidance until final regulations are adopted and have the same authority as final regulations but generally are valid for only three years from the date of issuance. In the rule making process, temporary regulations must be issued with proposed regulations. Proposed regulations are finalized once they undergo review by the public during the public comment period (a process that can take months or years). Until finalized, proposed regulations are not binding on the I.R.S. or taxpayers. See Code §7805.

11 See T.D. 9761 and T.D. 9812.

12 See Treas. Reg. §1.7874-3.

or 80% thresholds to avoid adverse tax consequences of Code §7874 by relying on the substantial business activities test.

Temporary and proposed regulations issued in 2016 would adopt several rules previously contained in I.R.S. notices,[13] including rules on multiple-step inversions. Generally, companies aim to keep inversions below the 60% ownership continuity threshold. That often requires multiple steps. In a typical multiple-step inversion, a foreign corporation acquires more than one U.S. corporation over a short period of time or through one or more corporate inversions that are not within the scope of Code §7874. Through these serial acquisitions or inversions, the value of the foreign corporation increases to the extent that it issues its stock in connection with each successive acquisition, allowing it to undertake another inversion transaction with a larger U.S. corporation while remaining below the 60% and 80% ownership continuity thresholds. In determining the ownership percentage by value, the regulations disregard the stock of the new foreign parent corporation to the extent the value of such stock is attributable to its prior U.S. corporate acquisitions during a specified three-year period.[14] To illustrate the effectiveness of this rule, the contemplated merger of Pfizer with Allergan met the 60% threshold.

## CASE STUDY: INVERSION RULES IN THE PRIVATE CLIENT CONTEXT

When advising individuals, including individuals who are not U.S. citizens, U.S. residents, or U.S. domiciled persons ("non-U.S. persons") it is not uncommon to encounter a client who has purchased or acquired property in the U.S. without planning for the tax consequences of owning the property.

Consider the case of a family of non-U.S. persons who purchase U.S. residential real property for personal use and to generate rental income. The family holds the properties directly. They first consult with a U.S. tax advisor after they purchased the U.S. real property, when the properties have greatly appreciated in value. The U.S. tax advisor duly advises that directly holding U.S. real property exposes a non-U.S. person to U.S. estate tax because non-U.S. persons are subject to U.S. estate tax on U.S.-situs real property. Moreover, the U.S. tax advisor advises that the tax rate and exemption amount applicable to non-U.S. persons are highly unfavorable.[15]

The U.S. tax advisor then proposes that they hold the U.S. real property through a structure that is typically implemented for non-U.S. persons. Under the proposed plan, each property will be transferred to a newly formed U.S. corporation ("U.S. Co" or jointly "U.S. Co.'s") pursuant to a transfer in exchange for shares in the entities. This type of transaction typically is tax-free under Code §351. Two foreign corporations (each "F Holdco" or jointly "F Holdcos") will be formed in a low-tax jurisdiction. Each U.S. Co.'s shareholder will transfer all shares held to one of the F Holdcos in exchange for stock of such entity.

As a result of the restructuring, the family will indirectly own the U.S. real property through the F Holdcos, which own the U.S. Co.'s that hold the properties. Under this

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13 See T.D. 9812.

14 See Treas. Reg. §1.7874-8T.

15 Non-U.S. persons have only a $60,000 exemption on the value of their U.S.-situs assets includable in their gross estate.

structure, the estate tax exposure is eliminated because the shares of the F Holdcos are not U.S.-situs property.

A closer consideration, however, suggests that the proposed plan may have negative U.S. tax consequences. First, under a tax regime introduced by the Foreign Investment in Real Property Act ("F.I.R.P.T.A."), the transfer of a U.S. real property interest ("U.S.R.P.I."), such as an ownership interest in U.S. residential real property, by a foreign person requires the foreign person to recognize income on the property's built-in gain. A U.S.R.P.I. includes an interest in a U.S. real property holding company ("U.S.R.P.H.C."), which is a U.S. corporation with 50% or more of the fair market value of its assets consisting of U.S.R.P.I.'s. However, under an exception to the general recognition rule, such a transfer generally would not trigger gain recognition, provided some additional requirements are met. The rationale for this exception is that the F Holdcos, as foreign persons, remain subject to the general gain recognition rule under F.I.R.P.T.A. when they transfer the U.S. Co.'s. or the underlying U.S.R.P.I.'s.

Thus, under the general gain recognition rule, the family's transfer of the shares of the U.S. Co.'s to the F Holdcos would result in the recognition of the built-in gain in the U.S. residential real property held by the U.S. Co.'s, but the tax can be deferred if the exception applies.

After considering the above issues, the U.S. tax advisor might decide that the U.S. analysis is complete since he or she knows that transfers to the U.S. Co.'s and F Holdcos will not trigger F.I.R.P.T.A. gain and the structure works to protect the clients from U.S. estate tax liability. However, on closer consideration, it appears that the proposed plan contains all of the elements of a corporate inversion under Code §7874, as follows:

- Each F Holdco is a surrogate foreign corporation because it acquired all of the properties constituting a trade or business of the U.S. Co.
- After the acquisition, 100% of the stock of each F Holdco is held by the former shareholders of the U.S. Co.'s.
- The expanded affiliated groups (*i.e.*, the groups that now include the F Holdcos and the U.S. Co.'s as subsidiaries) do not have substantial business activities in the foreign country in which the F Holdcos were organized since the F Holdcos are acting solely as holding companies.

Each U.S. Co. is an expatriated entity with respect to which each F Holdco is a surrogate foreign corporation. Since the inversions meet the 80% ownership continuity threshold, the inversions should not be respected under Code §7874, given a literal reading of the statute. As a result, the F Holdcos will be treated as U.S. corporations for all purposes of the Code. The clients will be subject to withholding tax on dividends from the F Holdcos and their interests in the F Holdcos may be required to be reported on Form 5472 and Form 1120. Moreover, the original objective of removing the properties from the reach of U.S. estate tax is thwarted since shares in a U.S. corporation, such as the shares of the F Holdcos under Code §7874, are U.S.-situs property.

Note that none of the facts surrounding the anti-inversion rules are present in this situation, yet it is still subject to their effects. There are no public companies, no permanently invested earnings in offshore subsidiaries, and no elimination of tax on

income repatriated to the U.S. These are powerful policy reasons for arguing the anti-inversion rules should be applicable only when U.S.-based multinational groups are involved in the inversion transaction. If U.S. estate tax is repealed for non-U.S. persons owning shares of U.S. corporations, another policy reason is added to the mix.

Regrettably, private individuals do not make U.S. tax policy and U.S. tax advisors may wish to follow U.S. tax law literally. Consequently, how can the U.S. estate tax exposure be reduced?

***"Anti-inversion rules should be applicable only when U.S.-based multinational groups are involved in the inversion transaction."***

One possibility is to introduce into the structure a foreign partnership ("F.P.") or a foreign eligible entity that can make an election to be treated as a partnership under U.S. tax law. Under the revised plan, at least three members would own interests in the F.P., no family member would own a controlling interest, and neither the death of any individual member nor the bankruptcy of a corporate member would cause the F.P. to be terminated under local law. The clients would then contribute the shares of the F Holdcos to the F.P. in exchange for a capital or profits interest. Even if the F.P. were to be viewed as a domestic partnership for income tax purposes, it may nonetheless not be an item of U.S.-situs property for estate tax purposes.

Authority, in the form of a published I.R.S. ruling, addresses the situs of an interest in a U.S. domestic partnership that actively conducted business in the U.S.[16] The question was whether a partnership interest held by a foreign individual at the time of his death had U.S. or non-U.S. situs. If the situs of the partnership interest was in the U.S., the partnership interest was subject to U.S. estate tax. On the other hand, no U.S. estate tax would apply if the partnership interest had a non-U.S. situs. While the context of the ruling was an estate tax treaty of the U.S., the I.R.S. applied general principles not inconsistent with U.S. law.

The I.R.S. did not consider the place of formation of the partnership nor the residence of the decedent to be controlling. The ruling looked at three ways to resolve the issue:

- The decedent's interest constitutes a debt[17] and, consequently, under the terms of Article III(2)(c) of the treaty is situated at the place of his domicile.
- The situs of his interest is where the individual items of the partnership assets are located.
- The situs of a partner's interest is where the business is carried on.

The ruling concluded that an ownership interest in a partnership that does not terminate with the death of the partner is an asset that is separate and apart from the assets owned by the partnership. A partner cannot sell his or her undivided interest in the partnership assets to a third person and, therefore, cannot be held to own the assets legally owned by the partnership. This view applied in a state case involving a local estate tax. The court determined that a decedent's interest in a partnership was intangible property and not an interest in a portion of the underlying real property owned by the partnership. However, where a partnership actively carries on a

[16] Rev. Rul. 55-701, 1955-2 C.B. 836.

[17] The possibility that the partnership interest constituted debt is based on the principle that, on dissolution of a partnership, a partner is entitled to share in what would remain of the partnership assets net of liabilities.

business within a jurisdiction, the partnership interest held at death by the decedent is properly subject to estate tax in that jurisdiction.

This approach is not inconsistent with an earlier case[18] in which a Federal court of appeals held that the situs of an interest in a Cuban entity terminating on the decedent's death was controlled by the location of the underlying assets owned by the Cuban entity. In Rev. Rul 55-701, the entity continued in existence at the death of the partner. In the case involving the Cuban entity, the legal existence of the entity terminated under local law with the death of a partner. Consequently, the decedent's share of the assets in the partnership were, in effect, owed to the decedent, and therefore, the situs of those assets was viewed to be controlling.

Note that one tax reform proposal currently under consideration treats gain from sale of a partnership interest by a non-U.S. person as effectively connected gain to the extent that the assets of the partnership would result in effectively connected gain if the partnership were to affect the sale.[19] This is a manifestation of the aggregate theory of partnerships and, if adopted, would negate the effect of the plan.

## CONCLUSION

Though much of the attention on corporate inversions is focused on large U.S. multinationals expatriating by becoming subsidiaries of large foreign multinationals, the above case study demonstrates that the two-tier corporate structure, often used in the structuring of U.S. investments of non-U.S. persons, can fall within the scope of Code §7874 if not properly implemented and have disastrous U.S. estate tax consequences.

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[18] *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934).

[19] See Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, p. 145.

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