Client Alert | Tax

Treasury Department Issues Temporary and Proposed Regulations to Curb Inversions and Earnings Stripping

April 2016

Authors: **Andrew Kreisberg**, **Narissa Lyngen**, **John Sasopoulos**

On April 4, 2016, the Internal Revenue Service and the Treasury Department issued temporary and proposed regulations formalizing rules contained in Notices 2014-52 and 2015-79 limiting corporate tax inversions, as well as adding new rules addressing inversions and earnings stripping transactions. The new rules covering inversions affect transactions that are happening currently in the marketplace, while the earnings stripping rules can impact intercompany debt arrangements in a surprisingly wide array of circumstances that go well beyond inversions.

Introduction

On April 4, 2016, the Internal Revenue Service ("IRS") and the Treasury Department issued temporary and proposed regulations formalizing rules contained in Notices 2014-52 and 2015-79 limiting corporate tax inversions, as well as adding new rules addressing inversions and earnings stripping transactions. The rules specifically targeting inversions were issued as final and temporary regulations (T.D. 9761) and as proposed rules (REG-135734-14) that cross-reference the final and temporary regulations (the "Anti-Inversion Regulations"). The regulations on earnings stripping came in proposed form (REG-108060-15) (the "385 Regulations").

Key Points

- The most notable items in the Anti-Inversion Regulations include:
  - a new rule disregarding a foreign corporation's prior acquisitions of US companies when measuring whether a subsequent acquisition of a U.S. company constitutes an inversion (the "Multiple Domestic Entity Acquisition Rule"),
  - a new rule that addresses back-to-back foreign acquisition structures, whereby a foreign corporation acquires a U.S. company and is then itself acquired by an additional foreign corporation as a means to avoid the ownership thresholds or to satisfy the "substantial business activities" exception (the "Multiple-Step Acquisition Rule"), and

- new rules regarding post-inversion transfers by controlled foreign corporations ("CFCs") of assets under Section 351 (the "CFC Rules").[1]

- The 385 Regulations create new rules that:
  - treat related party debt issued or exchanged pursuant to certain transactions as stock for tax purposes (the "Classification Rule"),
  - impose certain documentation requirements that must be met in order for a purported debt instrument to be treated as debt (the "Documentation Rule"), and
  - authorize the Commissioner to treat a single instrument as part-debt and part-equity, in sharp contrast with the all-or-nothing rule under existing debt-equity authorities.

Inversions

A. Existing Law Prior to the Anti-Inversion Regulations

Section 7874 of the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations thereunder, are intended to sustain the taxing jurisdiction of the IRS over U.S. corporations and partnerships that redomicile in a foreign jurisdiction. The transactions at issue generally involve a foreign corporation acquiring substantially all of the properties of the U.S. entity in exchange for its stock. If the former domestic entity owners wind up with 80% or more of the foreign corporation (such former domestic entity owners' percentage interest in the new foreign parent, the "ownership fraction"), and the foreign corporation's "expanded affiliated group" does not have substantial business activities in its country of organization as compared to its worldwide activities, the foreign corporation is treated as a domestic corporation for U.S. federal income tax purposes. If the ownership fraction is at least equal to 60%, but less than 80%, the foreign corporation is treated as a foreign corporation but is limited in its ability to use certain losses and other tax attributes for a 10-year period.

The anti-inversion rules were amplified by two IRS notices beginning in October 2014. Notice 2014-52 limited the ability of U.S. companies to engage in inversion transactions by tightening the ownership fraction calculation by (1) excluding passive assets from the valuation of a new foreign parent, thereby reducing the new foreign parent's value and (2) disregarding any extraordinary dividends paid by a former U.S. parent prior to an inversion, thereby increasing the former U.S. parent's value, among other measures.

Notice 2014-52 also included rules intended to prevent circumvention of Subpart F, including treating the stock or debt of a related foreign entity as U.S. property for purposes of Section 956 when acquired by a CFC of an expatriated domestic entity (the "anti-hopscotch" rule).

Notice 2015-79 augmented the 2014 notice and made minor corrections. The 2015 notice narrowed the 25% "substantial business activities" exception by requiring that the new foreign parent be a tax resident of the country in which it is organized in order for the exception to apply. It strengthened the 80% test by introducing the "third country" rule, which, for purposes of calculating the ownership fraction, disregards stock of a new foreign parent that is issued to shareholders of the existing foreign combining entity where such new foreign parent is located in a third country (generally resulting in the U.S. company shareholders owning 100% for purposes of the calculation). Notice 2015-79 also limited tax benefits associated with certain post-inversion transactions, mainly relating to property leaving a CFC of the inverted U.S. entity (or the stock of the CFC being transferred to the new foreign parent), similar in concept to the anti-hopscotch rule described above.

[1] Unless otherwise noted, all "Section" references are to the Code.

B. Anti-Inversion Regulations

The Anti-Inversion Regulations released on April 4, 2016 enact with few modifications the rules described in Notices 2014-52 and 2015-79 and also include several new rules targeting inversions and certain post-inversion transactions.

1. Multiple Domestic Entity Acquisition Rule

The most notable of the new rules is one that targets inversion transactions involving a new foreign parent that previously acquired one or more U.S. entities in inversions or acquisitions in which the new foreign parent issued stock. These prior acquisitions would generally increase the value of the foreign entity, enabling it to subsequently engage in an inversion transaction with a larger U.S. company while remaining below the 60% or 80% ownership thresholds. The temporary regulations restrict such subsequent acquisitions by disregarding stock of the new foreign parent to the extent the value of such stock is attributable to its prior U.S. entity acquisitions. The Multiple Domestic Entity Acquisition Rule is applicable to prior transactions that occur within the three-year period ending on the signing date of the relevant inversion transaction.

2. Multiple-Step Acquisition Rule

The Multiple-Step Acquisition Rule targets certain inversions that are structured as back-to-back foreign acquisitions. The transactions at issue are ones in which, pursuant to a plan, a foreign corporation acquires substantially all of the assets of a U.S. entity and, subsequent to this first acquisition, a second foreign corporation acquires substantially all of the assets of the first foreign corporation, with the taxpayer taking the position that the second acquisition is not a domestic entity acquisition (and, on occasion, even that the second acquisition should result in the first acquisition failing to so qualify). The temporary regulations provide that, where certain conditions are satisfied, the subsequent acquisition will be treated as an acquisition of a U.S. entity that may be subject to Section 7874 and that Section 7874 may apply simultaneously to both the initial acquisition and the subsequent acquisition. Unlike the Multiple Domestic Entity Acquisition Rule which has a three-year look-back period, the Multiple-Step Acquisition Rule will be applied as far back as possible to show that an earlier acquisition was made under the same plan as a later acquisition.

3. CFC Rules

Among the new rules intended to prevent circumvention of Section 956 and the CFC rules is one that addresses situations in which a CFC of an inverted U.S. group engages in a post-inversion Section 351 exchange that could dilute a U.S. shareholder’s indirect interest in the exchanged asset, allowing the U.S. shareholder to avoid U.S. tax on any realized gain in the asset that is not recognized at the time of the transfer. The CFC Rules require a CFC of an inverted U.S. group to recognize all realized gain with respect to any such post-inversion Section 351 exchange.

4. Effective Date of Anti-Inversion Regulations

The rules in the temporary regulations that implement the rules described in Notice 2014-52 and Notice 2015-79 generally apply to transactions completed on or after September 22, 2014 and November 19, 2015, respectively. The new rules in the temporary regulations are applicable to transactions completed on or after April 4, 2016.

Earnings Stripping Transactions

A. Existing Law Prior to the Section 385 Regulations

In Notices 2014-52 and 2015-79, Treasury and the IRS highlighted their concern about transactions involving the use of indebtedness in order to facilitate the stripping of the U.S. tax base of a corporate group following an inversion transaction. For example, a U.S. corporation may erode its U.S. tax base by making deductible payments to its inverted parent which, in turn, may be subject to little or no tax. In addition, a U.S. corporation may be able to repatriate untaxed E&P from CFCs in the form of a nontaxable return of capital by having the CFC distribute a note to the U.S. corporation in a year that the CFC has no E&P and making payments thereon in subsequent years.

The primary means of attacking earnings stripping that pre-dates the Section 385 Regulations is Section 163(j). Under Section 163(j), interest deductions are generally deferred to the extent of the borrower's "excess interest expense" (generally, net interest expense over 50% of adjusted taxable income) where the borrower's debt/equity ratio exceeds 1.5/1 and interest is paid to a related party that does not recognize taxable income on the payment.

Under existing law prior to the Section 385 Regulations, whether an instrument is classified as debt or equity depends on a list of judicially developed factors that look upon the substance of the transactions and the intent of the parties.

The 385 Regulations introduce rules that affect the classification of instruments in related party transactions, and which supplement the judicially developed rules under existing debt-equity authority.

B. Section 385 Regulations

1. Classification Rule

Under the Classification Rule, related-party debt that is issued, distributed or exchanged in certain transactions will be characterized as equity for tax purposes, even if under existing debt-equity authority such instruments are treated as indebtedness. The result of equity classification is that interest deductions will be disallowed, and withholding obligations of 30% (or lower rate based on an applicable income tax treaty) could ensue.

The Classification Rule generally applies to the issuance of debt by a corporation to a member of its "expanded group" (generally, an affiliated group as defined in Section 1504, subject to various expansions, such that it includes foreign and tax-exempt corporations, for example) in each of the following situations:

- as a distribution, with no cash received in exchange therefor,
- in exchange for stock of an expanded group member,
- in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation,
- in exchange for property with a principal purpose of funding a transaction generally described in the first three bullet points above, and
- with a principal purpose of avoiding application of the 385 Regulations.

The Classification Rule does not apply if (i) the distributing or acquiring corporation has E&P in excess of the amount of the distribution or acquisition (as the case may be); or (ii) the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under the 385 Regulations does not exceed $50 million (measured at the time that the instrument is issued), among other exceptions.

2. Documentation Rule

The Documentation Rule imposes certain documentation and information requirements with respect to debt instruments issued and held by certain members of an expanded group in order to establish that such instruments are properly characterized as debt. These requirements are not a safe harbor but rather merely a minimum standard that enables the determination to be made under general federal tax principles. If these requirements are not satisfied when applicable, the instrument will be treated as stock.

The Documentation Rule applies to debt instruments issued between members of an expanded group if: (i) the stock of any member of the group is publicly traded; (ii) total assets on an applicable financial statement including any member of the group exceed US $100 million, or (iii) annual total revenue on an applicable financial statement including any member of the group exceeds US $50 million.

To satisfy the Documentation rule, there must be written documentation establishing that:

- the issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates,
- the holder has the rights of a creditor to enforce the obligation, generally including, but not limited to, the right to cause or trigger an event of default or acceleration of the debt (when the event of default or acceleration is not automatic) for non-payment of interest or principal when due, the right to sue the issuer to enforce payment and a superior right to shareholders to share in the assets of the issuer in case of dissolution,
- there is a reasonable expectation of repayment, which may include cash flow projections, financial statements and other information regarding the sources of funds enabling the issuer to meets its obligations under the terms of the instrument, and
- there is a genuine debtor-creditor relationship, including documentation providing evidence of payments of principal and interest or, if such amounts have not been paid when due, documentation evidencing the holder's reasonable exercise of the diligence and judgment of a creditor.

3. Effective Date of Section 385 Regulations

The Classification Rule is proposed to apply to any debt instrument issued on or after April 4, 2016 and to any debt instrument issued before April 4, 2016 as a result of an entity classification election filed on or after April 4, 2016. Under a grandfathering rule, if the application of the Classification Rule would result in a debt instrument being treated as stock, the stock treatment will be effective beginning on the day that is 90 days after the proposed regulations become final.

The Documentation Rule is proposed to apply with respect to any applicable instrument issued (or deemed issued) on or after the date that the Section 385 Regulations are finalized.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

T +1 212 819 8200