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Corporate Inversions: Wider Net Cast By Treasury And IRS Impeding Cross-Border Mergers And Acquisitions Amidst Calls For Tax Reform

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Introduction

Although Section 7874 of the Code was enacted nearly 13 years ago, IRS regulations continue to evolve and become more complex despite substantial public criticism by the business community, and even an ongoing court challenge by the US Chamber of Commerce, questioning both their validity and role in the US tax system.[1]

A corporate inversion transaction in broad terms involves a transfer of stock or assets of a US corporation or partnership to a foreign corporation that is owned by the same group of shareholders or partners by reason of such transfer. Where the inversion rules apply, there are different consequences depending on the degree of ownership continued by the former owners of an acquired US entity. In the case where the former owners receive at least 80 percent of the acquiring foreign corporation stock, the acquiring corporation is treated as a domestic corporation for all purposes of the Code. Alternatively, where the former owners receive at least 60 percent but less than 80 percent of the foreign acquiring corporation stock, the latter is respected as a foreign corporation, but the US entity will recognize any inversion gain which broadly includes various forms of income over a ten-year period.[2]

Treasury regulations issued on April 4, 2016 (the "**2016 Regulations**") retroactively implement rules contained in IRS Notices issued in 2014 and 2015 and provide new rules that substantially diminish the viability of certain cross-border combinations. The 2016 Regulations give enormously strengthened power to the inversion rules to impede business combinations, despite strong non-tax purposes. Perhaps the most controversial regulation – a per se "multiple acquisitions rule" that applies to two or more unrelated acquisitions of US companies within a 36-month

period – was engineered by Treasury to effectively lower the ownership thresholds to trigger inversion status. The "multiple acquisitions rule" is at the center of the Chamber of Commerce's litigation papers claiming that Treasury exceeded its regulatory authority and violated federal law governing administrative agency action.

Part I of this article provides a general overview of the corporate inversion rules. Part II highlights recent regulatory changes aimed at widening their reach. Part III briefly considers the fate of the inversion rules in light of the different forces for tax reform and the legal challenge by the Chamber of Commerce.

Part I – Inversion Conceptual Overview

Section 7874 applies when three tests are met: (i) a foreign corporation acquires substantially all of the properties held directly or indirectly by a US corporation or substantially all of the properties constituting a trade or business of a US partnership (the "**Acquisition Test**"), (ii) the former shareholders or partners, as the case may be, own at least 60 percent by vote or value of the acquiring foreign corporation by reason of their ownership of the acquired US corporation or partnership (the "**Continuity Test**"), and (iii) the newly-foreign-parented corporate group in which the foreign acquiring corporation is a member (called the "expanded affiliated group" or "**EAG**") does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created (the "**SBA Test**").[3] For purposes of the Acquisition Test, the acquisition of stock of a US corporation or interests in a US partnership is treated as an indirect acquisition of a proportionate amount of the properties of the corporation or partnership.[4]

An EAG satisfies the SBA Test if four factors are present: (i) at least 25 percent of the total EAG employees are based in the relevant foreign country and the total compensation of those employees is at least 25 percent of the total EAG employee compensation; (ii) the value of the EAG assets located in the relevant foreign country is at least 25 percent of the total value of all EAG assets (based on gross value); (iii) EAG income derived in the relevant foreign country is at least 25 percent of the total EAG income; and (iv) the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.[5] As discussed below, this last "subject to tax as a resident" requirement in the relevant foreign country applies to transfers completed on or after November 19, 2015.[6]

If Section 7874 applies and the 80 percent ownership threshold of the Continuity Test is met, the foreign acquiring corporation is treated for all federal tax purposes as a US corporation.[7] A

re-characterization of a foreign acquiring corporation as a US corporation has important federal tax implications, as a foreign corporation is generally only subject to US income tax on certain US source income (and in certain limited cases foreign source income), while a US corporation is generally subject to US income tax on its worldwide income, among other consequences.

While existing Treasury Regulations governing corporate inversions have been in place for a number of years, the new regulations focus on certain transactions that are structured to avoid Section 7874 [8] and incorporate rules previously introduced in Notice 2014-52 (the "**2014 Notice**")[9] and Notice 2015-79 (the "**2015 Notice**").[10] These rules, highlighted herein, impede the avoidance of inversion status by, *inter alia*, changing the size of either the acquired US corporation or the foreign acquiring corporation or by imposing limitations on where the foreign acquirer might be based.

Part II – Regulatory Rules That Reduce Ability To Avert Inversion Status

Substantial business activities (SBA)

The SBA Test has been modified by Treasury various times over the past ten-plus years in the Government's effort to make it more difficult to plan around inversion status by meeting the SBA factors – *i.e.*, having substantial employees, assets and income in the country of the foreign acquiring corporation.

Regulations adopted in 2012 added the 25 percent bright-line tests to the SBA Test as described above, replacing a facts and circumstances test that governed unless a 10 percent safe harbor was met. The change from 10 percent to 25 percent represents an increase of considerable magnitude, materially reducing the likelihood that the exception can be met.

The 2016 Regulations dramatically expanded the three-factor test to include a new fourth prong under which an EAG will be treated as having substantial business activities in the foreign country in which the foreign acquiring corporation is created only if it is also "subject to tax as a resident of the relevant foreign country." [11] The regulation does not clarify what is required to meet this standard and therefore leaves new questions (such as what minimum local corporate tax regime is sufficient and how to classify companies taxable outside their country of formation because of management and control). This new factor, along with the prior move to the 25 percent bright-line test, will impede reorganizations into tax haven jurisdictions, the hallmark of the earlier inversion transactions.

Another significant feature of the SBA Test added in 2006 regulations is the exclusion of intangible assets from the SBA asset factor (which requires at least 25 percent of the value of the EAG's

tangible personal and real property to be located in the relevant foreign country). The regulations, however, do not require a physical presence of "mobile" tangible assets used in transportation in the relevant foreign country required on the inversion acquisition date under the general rule (but the assets must be present in that country more than any other country).[12]

Further clarity to the EAG employee/compensation test was added by 2015 regulations. They specify that the amount and timing of employee compensation under the employee factor is determined under either US federal income tax principles or the tax law to which the relevant EAG member is subject. However, the issue of whether the service provider is an "employee" for purposes of the SBA Test must be determined for *all* EAG employees under *either* US federal income tax law or the relevant foreign country law.

Finally, the 2016 Regulations add guidance to the process of making EAG member and income determinations under the 25 percent income test.[13]

Aggregation of domestic entity acquisitions – intent-based and per se rules

Perhaps the most potent anti-inversion tools sit in the "multiple acquisitions" rules of Treas. Reg. § 1.7874-2 and Treas. Reg. § 1.7874-8T, which each negate the separate effect of certain prior US entity acquisitions that essentially "fatten up" the foreign acquiring corporation in size and, in turn, reduce the percentage of its stock that the shareholders of the last acquired US entity would otherwise hold by reason of the acquisition.

Treas. Reg. § 1.7874-2, issued in 2009, first formulated a multiple acquisitions rule which aggregates *related* acquisitions of domestic corporations that occur as part of a "plan or series of related transactions." Under this rule, foreign acquiring corporation shares issued as part of related US entity acquisitions are counted in the inversion ownership test and treated as issued in a *single* acquisition. This aggregation rule has the effect of causing inversion status though neither acquisition by itself (without such piggybacking) would meet the minimum 60 percent ownership threshold.[14]

The 2016 Regulations expand the 2009 aggregation rule with a *per se rule* for acquisitions occurring in a 36-month time frame, applied *without regard* to intent or plan. The per se rule, rather than aggregating acquisitions, excludes foreign acquiring corporation stock issued in the prior acquisitions from the denominator of the inversion ownership test. The only leeway given by the per se rule is an exception for small acquisitions where *both* (i) the inversion ownership test applied solely to the small acquisition is less than 5 percent *and* (ii) the fair

market value of the foreign acquiring stock received by the small company's shareholders is USD50m or less.[15]

The per se test 36-month look-back period ends on the signing date of the acquisition at issue.[16] Although the per se multiple acquisition rule is effective for acquisitions *after* April 4, 2016, it takes into account acquisitions before such date under the 36-month look-back test. Further, under an ordering rule, the intent rule is applied before the per se rule.[17]

The per se rule, which was launched by Treasury with immediate effect and significantly without any new regulation notice and comment period, is likely the single most controversial aspect of the inversion rules. The regulation's preamble clearly explains Treasury's rationale that the 2009 aggregation rule requiring actual (not temporal) relatedness was not sufficient:

> "The Treasury Department and the IRS do not believe that the application of section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior entity acquisitions." *Inversions and Related Transactions*, 81 Fed. Reg. at 20,865.

The 2009 multiple acquisition rule was not controversial since its plan requirement is at least near the margin of the legislative mandate of Section 7874(g) authorizing regulations that prevent avoidance of the section. In contrast, the 2016 expansion negates the effect on the ownership test of prior unrelated and *bona fide* acquisitions, involving different US entities with no relationship whatsoever to the acquisition at issue and no intent to assist avoidance of the inversion ownership thresholds.

This dramatic change in the ownership test under the 2016 expansion, with its immediate effective date and 36-month look-back period, carries a sweeping effect to stop certain high-profile pending as well as future deals, as admitted by supporters in Congress such as Representative Sander Levin.[18]

Strong objection quickly came from the business community in a case brought in August 2016, *Chamber of Commerce of the United States of America et al. v. IRS et al. (No. 1:16-cv-00944)*, which challenges the validity of the Treas. Reg. § 1.7874-8T multiple acquisition rule. The action centers on the admitted purposes of Treasury and its exercise of unauthorized agency action including the attempt to legislate through administrative action. The Chamber of Commerce and Texas Association of Business, as the plaintiffs, are seeking to set aside the multiple acquisitions

rule as unlawful under the Administrative Procedure Act, 5 USC. § 706. Motions to dismiss and for summary judgment filed by the Government and Chamber of Commerce respectively were argued on January 18, 2017. The case has not yet been decided.

Slimming down distributions – the excess distribution rule

The 2014 Notice focused on a concern similar to the above multiple acquisitions issue, arising where the US corporation reduces its size, before the outbound transfer to a foreign acquirer, through distributions to reduce the inversion ownership percentage.[19]

Under the 2016 Regulations, non-ordinary course "excess" distributions by the US corporation during the 36-month period prior to the inversion transaction are disregarded (meaning thrown back as if they were not made). The excess distribution is the amount above 110 percent of the average of all distributions during the 36-month period (subject to special rules if there is an insufficient distribution history or look-back period). Distributions above the 110 percent threshold are deemed non-ordinary course. Distributions subject to this rule include regular dividends and distributions in redemption of stock, along with the transfer of money or other property to shareholders in connection with the inversion (to the extent the US corporation funds such money or other property).

The throwback of excess distributions and related adjustments is required irrespective of intent. This would generally catch a spin-off transaction that occurs for an entirely separate and *bona fide* business reason that has no connection to the inversion transaction (similar to the application of the per se multiple acquisitions rule). A special rule applies in order to create parity in the application of the rule to cases where a spin-off transaction could otherwise be restructured to circumvent the application of the rule (*e.g.*, by spinning off the target).[20]

Fattening up the foreign acquirer – the passive asset and disqualified stock rules

If a foreign corporation that acquires a US corporate or partnership entity owns passive assets (such as cash and marketable securities), a portion of the foreign acquiring corporation's stock could be disregarded when computing the ownership thresholds under the Continuity Test.[21] This rule seeks to prevent a foreign corporation with a large amount of passive assets from being used in a corporate inversion transaction to avoid a corporate inversion.

The passive asset rule applies if more than 50 percent of the value of the assets of a foreign acquiring corporation is comprised of passive assets ("**nonqualified property**"). If the passive asset rule

applies, then a portion of the stock of the foreign acquiring corporation attributable to passive assets is excluded from the denominator of the ownership fraction under the Continuity Test. This exclusion negates the dilutive impact passive assets would otherwise have in terms of the amount of foreign acquiring stock issued to the acquired US entity's shareholders.

Passive assets treated as nonqualified property include cash or cash equivalents, marketable securities, certain obligations of related parties, property acquired with a principal purpose of avoiding the purposes of Section 7874, and property that is acquired in exchange for other property, including cash, if such other property would be a passive asset had the acquisition not occurred.[22]

The passive asset rule exclusion of foreign acquiring corporation stock from the Continuity Test safeguards a similar concern previously addressed by Treas. Reg. § 1.7874-4 that excludes from the ownership computation so-called "**disqualified stock**." Disqualified stock is foreign acquiring corporation stock transferred in an exchange for "nonqualified property" (including cash and marketable securities) that is *related* to the domestic entity acquisition. Such disqualified stock does not include stock transferred to the domestic entity. Finally, although the original rule excluding such newly-issued stock set forth in Section 7874 is premised on public issuer status, under the regulations disqualified stock status does not require that the foreign corporation be publicly traded.

Accordingly, both recently issued stock and assets of a foreign acquiring corporation should be reviewed to determine if either there is disqualified stock or passive assets that would impact the inversion ownership test and cause an inversion or change its consequences.

Third country acquisition corporations

The 2016 Regulations adopt the "**third country rule**" essentially as set forth by the 2015 Notice, which disregards stock of the foreign acquiring company issued to shareholders of another foreign corporation acquired in a transaction *related* to the acquisition of the domestic entity. The third country rule is similar to the multiple acquisitions rule, but limits its focus to *related* acquisitions involving a foreign (instead of a domestic) corporation. The rule generally increases the ownership fraction and likelihood that an inversion will occur.[23]

A third country transaction generally occurs when (i) a US target corporation and a foreign corporation combine in *related* transactions involving a separate foreign "parent" corporation which is a tax resident outside the foreign country where the other foreign corporation is tax resident,

(ii) the foreign "parent" corporation acquires both the US entity and the foreign corporation, (iii) shareholders of the other foreign corporation receive at least 60 percent of the stock of the foreign parent corporation (computed without reference to the US target corporation acquisition), and (iv) the ownership percentage under the Continuity Test, without regard to the application of the third-country rule, is at least 60 percent.[24]

The Treasury Department justifies the third country rule on its view that locating a new foreign "parent" corporation outside of both the US and the country of the foreign acquirer generally gains access to a beneficial tax treaty network or a more favorable tax system with less rigid controlled foreign corporation rules, and facilitates US tax avoidance after the acquisition.[25]

Post-inversion related events: internal group restructurings, spins and stripping of earnings and asset value

Regulations also address certain internal group restructurings and transactions where there is a loss of control by former shareholders of the US corporation. Another set of rules applicable to subsequent transfers have one exception for a US-parented group and another for a foreign-parented group.[26]

The 2016 Regulations also cover the stripping of earnings and profits and asset appreciation of foreign corporations, constituting CFCs of the US corporation, without US income tax through various techniques including loans, intragroup sales, and non-recognition de-control transactions.[27]

Part III – Where Do We Go From Here?

Treasury and the IRS may be at the end of the road in creating any further complexity under the inversion rules, but not because there is little subject matter left on which to prescribe further rules. Rather, given the diametrically different policy direction of the Trump Administration relative to the Obama Administration, rule-making has come to a halt within Treasury and the IRS.

President Trump in a January 30, 2017 executive order first laid down a requirement of two-for-one, meaning that for each regulation proposed or promulgated, at least two existing regulations shall be identified to be repealed. On April 21, 2017, he then signed an executive order requiring the Secretary of the Treasury to immediately review all significant tax regulations issued by the Department of the Treasury on or after January 1, 2016.

But the cleanest approach to eviscerating the vigor of the inversion rules, apart from regulatory simplification and repeal, may be wholesale legislative change to the US international corporate tax

system. If the US Congress enacts any of the far-reaching changes proposed for the US tax system, such as lowering US corporate income tax rates, adopting a territorial-based system or implementing a border adjustment tax system, or even providing tax reduction upon repatriation of earnings accumulated by subsidiaries of US companies offshore, the calculus to reorganize under a foreign parent company could materially change and diminish the economic rationale for inverting.[28]

Therefore, on the horizon US tax legislation could radically impact the import of the inversion rules in their present state. Yet, such a tax overhaul is presently uncertain both in terms of timing and extent. Nearly half way into 2017 the tax reform initiatives of the US House of Representatives and the Trump Administration greatly differ, particularly on the international front, and neither set of initiatives suggests a straight legislative repeal of the inversion rules.

In the meantime, while Treasury is frozen by President Trump's executive order from taking further regulatory action and while Congress debates what might in effect be practical solutions and a long-term fix to the inversion dilemma, legal challenge to Treasury's 2016 multiple acquisitions rule moves forward. Until any of these forces rises to give a clear new direction, cross-border acquisitions of US companies may remain stymied by Treasury's efforts into 2016 increasing the reach of the inversion rules – now, every foreign company that is looking for its first US acquisition, or instead is contemplating further acquisitions, and their US acquisition candidates, each attracted to the combination for business reasons, must carefully weigh the impact of the multiple acquisitions rule on their next steps.

Interested persons should pay special attention to this area of the law over the coming months.

Endnotes

1 All references are to the Internal Revenue Code of 1986, as amended, and to the regulations promulgated thereunder. Section 7874 was added to the Code by Sec. 801 of the American Jobs Creation Act of 2004, P.L. 108-357.

2 Inversion gain that must be recognized in this second scenario cannot be offset by the US entity's tax attributes such as net operating losses, credits, and other income offsets. A 15 percent excise tax applies to certain deferred executive compensation pursuant to Section 4985.

3 IRC Section 7874(a)(2). An EAG very generally is defined as a chain of corporations connected by 50 percent ownership (measured by vote or value). IRC Section 7874(c)(1).

4 Treas. Reg. § 1.7874-2(c).

5 Treas. Reg. § 1.7874-3.

[6] Treas. Reg. § 1.7874-3T(f)(2) (adding the tax residency test first published by Notice 2015-79, 2015-49 I.R.B. 775).

[7] IRC Section 7874(b). This is treated as an inbound tax-free Section 368(a)(1)(F) reorganization of the acquiring foreign corporation for US tax purposes. Treas. Reg. § 1.7874-2(j).

[8] T.D. 9761, April 4, 2016. The Treasury Department issued technical corrections to correct certain errors in the originally-issued Temporary Regulations. The corrections were published on June 23, 2016 in the Federal Register, Vol. 81, No. 121. The Treasury Department also corrected its corrections, and published those additional corrections on July 19, 2016 in the Federal Register, Vol. 81, No. 138. The correction publications correct important technical details of the Temporary Regulations. Additional Treasury regulations were issued in January 2017 under T.D. 9812.

[9] 2014-42 I.R.B. 712.

[10] 2015-49 I.R.B. 775.

[11] Treas. Reg. § 1.7874-3T(b)(4).

[12] Treasury's more flexible test for "mobile" tangible assets carries both logic and fairness given the nature of transportation assets, but the tougher position that excludes intangible assets from the SBA asset test altogether is difficult to rationalize as within the scheme contemplated by Congress in adopting Section 7874 in 2004. While Treasury may have had a similar concern on the mobility of IP assets, in excluding intangible assets entirely, Treasury had nothing to rely on in the statutory language or legislative history to lead it to design absolutely disparate treatment of intangible assets. Any concerns about inverting companies also transferring their IP outbound to low-tax jurisdictions should be sufficiently safeguarded by the labyrinth of rules prescribed under Section 367 (particularly the latest regulations).

[13] Treas. Reg. § 1.7874-3T(d)(10). The 2016 Regulations clarify that in determining EAG income, the group financial statements cannot be used to identify which entities will be treated as EAG members, which is an issue to be determined by Section 7874. EAG income is determined over a one-year testing period using either US federal tax principles or US GAAP or IFRS accounting principles. The income test looks to only income earned in the ordinary course of business and from related parties.

[14] Treas. Reg. § 1.7874-2(e) and (k)(2)(Example 7).

[15] Treas. Reg. § 1.7874-8T(g)(4).

[16] Signing date means the first date on which the contract to effect the relevant domestic entity acquisition is a binding contract, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was a binding contract. Treas. Reg. § 1.7874-8T(g)(6).

[17] Treas. Reg. § 1.7874-8T(a).

[18] Interestingly, the 36-month look-back period runs from "any substantially similar acquisition" that was previously terminated with a principal purpose of avoiding Section 7874. *See* Treas. Reg. § 1.7874-8T(g)(6).

[19] The concern addressed by these anti-slim-down rules is a corollary to the concern arising where the acquiring foreign corporation is stuffed with passive assets to alter the inversion ownership test (discussed below under "Passive assets – fattening up the foreign acquirer") and similar concern where relative values of the foreign acquiring corporation and US target company are impacted by related acquisitions (discussed above). The anti-slim-down rules arguably are within the grant of authority to prevent avoidance of Section 7874, in contrast to the per se multiple acquisitions rule, since the excess distributions are made during the 36-month period by the same US target company.

[20] *See* Preamble Explanation of Provisions, Section I, B, 5, b, v (Domestic Entity Deemed To Have Distributed Stock of a Distributing Corporation in Certain Cases), T.D. 9761; Treas. Reg. § 1.7874-10T(g) states that "… if a domestic corporation (distributing corporation) distributes the stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355, and, immediately before the distribution, the fair market value of the stock of the controlled corporation represents more than 50 percent of the fair market value of the stock of the distributing corporation, then, the controlled corporation is deemed, on the date of the distribution, to have distributed the stock of the distributing corporation. The deemed distribution is equal to the fair market value of the stock of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution."

[21] Treas. Reg. § 1.7874-7T.

[22] Treas. Reg. § 1.7874-7T(f)(1); Treas. Reg. § 1.7874-4T(i)(7). However, nonqualified property does not include (i) property that gives rise to income derived in the active conduct of banking, financing, insurance or similar businesses (within the meaning of Section 954 and Section 1297), or (ii) certain other insurance related property.

[23] Treas. Reg. § 1.7874-9T(b).

[24] Treas. Reg. § 1.7874-9T(c). The third country rule is a further variation on the theme of the fourth prong of the SBA Test.

[25] Notice 2015-79, Section 2.02(b). Treasury believes that "a third-country parent typically is a low- or no-taxed entity chosen to erode the US tax base following the acquisition."

[26] The restructuring and spin rules set forth in Treas. Reg. §§ 1.7874-1T and 1.7874-6T were originally part of the 2014 Notice.

[27] This discussion does not address these rules in any detail but merely highlights their potential significance in every inversion transaction.

[28] *See* US House Ways and Means Committee, "A Better Way" Tax Blueprint (June 24, 2016), and Trump Administration tax reform plan (April 26, 2017).

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