Recent Anti-Inversion Guidance Has Meaningful Implications for Insurance Companies

October 7, 2014

The Treasury Department and the IRS recently released Notice 2014-52 (the "Notice"), which describes regulations that the government intends to issue to target the tax benefits of corporate inversions. The provisions of the Notice are summarized in our previous client memorandum dated September 23, 2014, ***Treasury Issues Long-Awaited Anti-Inversion Guidance***. **This Client Newsflash highlights a feature of the Notice that has not attracted much public attention, and that appears both to eliminate the ability of many foreign insurance companies to participate in inversion transactions and to impede the ability of many foreign insurance companies to acquire U.S. target companies using stock consideration.**

Passive Assets Generally

As has been widely reported, the Notice generally does not alter the 80% ownership test necessary under Section 7874 to effectuate a successful inversion transaction. Thus, even after the Notice, a domestic corporation can successfully invert by combining with a foreign corporation in a transaction in which the domestic corporation's shareholders own less than 80% of the combined company.

Observing that "[t]he Treasury Department and IRS are aware that taxpayers may be engaging in transactions with a foreign corporation that has substantial cash and other liquid assets in order to facilitate an inversion," the Notice introduces an anti-abuse rule that alters the 80% ownership test for companies that have disproportionately large passive holdings (the "**cash box rule**"). Where more than 50% of the foreign corporation's value is attributable to passive assets (including cash and marketable securities), the cash box rule operates by disregarding, for purposes of applying Section 7874's ownership tests, the value of a foreign corporation's stock that is attributable to those passive assets. Thus, if the cash box rule applies, when a domestic corporation attempts to acquire a foreign corporation in an inversion transaction, a portion of the pro forma corporation's stock that is held by the foreign corporation's shareholders "by reason of" their ownership of the foreign corporation is disregarded (and thus the percentage ownership held by the domestic corporation's shareholders "by reason of" their domestic corporation ownership is increased).

Application to Foreign Insurers

Sensibly, the Notice accounts for the fact that many bona fide financial institutions have large passive asset holdings that should not be considered abusive as a policy matter, and thus should be excepted from the cash box rule. Thus, for example, the Notice provides—by citation to the "passive foreign investment company" ("**PFIC**") rules—that property that gives rise to income "derived in the active conduct of a banking business by an institution licensed to do business as a bank" is not *per se* subject to the cash box rule. Accordingly, an active banking business will generally not be subject to the cash box rule in ways that differ from other operating businesses.

The PFIC rules also contain an active insurance exception, and the active insurance exception is very similar to the PFIC regime's active banking exception. However, the Notice does not incorporate the PFIC regime's active insurance exception. Rather, the Notice—seemingly tactically—adopts an insurance exception found in the more stringent "controlled foreign corporation" ("**CFC**") rules. Importantly, for an insurance company to comply with the CFC exception, at least 50% of its net written premiums from issuing or reinsuring insurance contracts must cover "applicable home country risks."

"Applicable home country risks" are risks that arise in the country in which the foreign insurance company is created or organized (or in the case of a branch, the country in which the branch's principal office is located and where the branch is licensed to sell insurance or reinsurance). Many foreign insurance companies (*e.g.*, Bermuda reinsurers) will not satisfy this home country risk requirement, and their assets, therefore, will be considered passive assets for purposes of the cash box rule.

This design choice in the Notice has significant consequences for foreign insurers:

- First, it appears that very few, if any, foreign reinsurers are now eligible to participate in inversion transactions because application of the cash box rule will meaningfully skew the Section 7874 ownership fraction toward the domestic corporation's shareholders; and
- Second, for the same reason, a "whale" foreign insurer could inadvertently become a U.S. corporation in a transaction in which it acquires a "minnow" U.S. corporation in exchange (in whole or in part) for its stock because, even on these seemingly benign facts, there is no apparent exception to the cash box rule. (The cash box rule would not apply to the acquisition by the same "whale" foreign insurer of the same "minnow" U.S. corporation in a transaction in which the only consideration paid by the foreign insurer is cash; however, many insurance acquisitions involve stock consideration for rating agency and other non-tax reasons.)

It is not clear why the Notice adopts one exception to the cash box rule for banks and a materially more onerous exception for insurance companies. However, the specific reference to the PFIC rules for the active banking exception and decision not to adopt an equally available exception for insurers—but to instead adopt the narrow CFC insurance exception—suggest that this was a deliberate design choice by the Treasury Department and the IRS. It is not clear, however, whether the Treasury Department and the IRS were aware of all of the implications of this design choice, especially with respect to the second consequence described above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Neil Barr	**212 450 4125**	**neil.barr@davispolk.com**
Rachel Kleinberg	**650 752 2054**	**rachel.kleinberg@davispolk.com**
Michael Mollerus	**212 450 4471**	**michael.mollerus@davispolk.com**

© 2014 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's **privacy policy** located at **davispolk.com** for important information on this policy. Please consider adding Davis Polk to your Safe Senders list or adding **dpwmail@davispolk.com** to your address book.

Unsubscribe: If you would rather not receive these publications, please respond to this email and indicate that you would like to be removed from our distribution list.