Treasury Issues New Anti-Inversion Guidance

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On April 4, 2016, the Internal Revenue Service (the "**IRS**") and the Treasury Department ("**Treasury**") issued (i) **final and temporary regulations** addressing inversion transactions (the "**New Inversion Regulations**") under Section 7874 (and certain other provisions of the Internal Revenue Code) and (ii) **proposed regulations** under Section 385 that would treat intercompany debt as stock in many situations.

While most of the New Inversion Regulations merely implement the rules announced in certain notices previously issued by the IRS and Treasury, (the "**Notices**"), they include new rules that expand (even further) when a transaction may run afoul of the inversion rules. In addition, the proposed Section 385 regulations would (if finalized in their current form) generally eliminate the incremental U.S. interest deductions on intercompany debt typically available after an inversion.[1]

These regulations reflect an expansive interpretation of authority on the part of the IRS and Treasury and exhibit a continued willingness to issue additional *ad hoc* rules that apply to pending transactions, without the benefit of any exception for announced and binding deals. However, while the regulations will make it more difficult and complicated to effect an inversion and will reduce some of the U.S. tax benefits of these transactions, there is every reason to believe that inversions will continue unless there is fundamental corporate tax reform in the United States.

Most Significant Changes Effected in the New Inversion Regulations

The most significant changes effected in the New Inversion Regulations include the following:

- **New "Prior Acquisition" Rule.** The regulations include an entirely new rule that applies when a foreign acquirer of a U.S. target (or the foreign acquirer's predecessor) acquired one or more other U.S. companies in exchange for stock (or stock and cash) during the prior three years (even if the various acquisitions are wholly unrelated). This new rule disregards the shares issued in the prior U.S. acquisitions (excluding those shares from the denominator of the inversion ownership fraction) for purposes of applying the inversion rules to the current U.S. acquisition. This rule is designed to prevent a foreign acquirer from benefiting from an increase in size as a result of one or more prior unrelated U.S. company acquisitions.
- **New "Non-Ordinary Course Distribution" Rules.** Additional provisions added to the so-called "non-ordinary course distribution" rules include:
    - Expansion of the "distributions" that must be "added back" in computing the value of the U.S. target to include distributions made by certain companies acquired by the U.S. target prior to the inversion in exchange for stock (or stock and cash), again, even if the acquisitions are wholly unrelated to the inversion.

[1] Although the proposed Section 385 regulations would (if finalized in their current form) have a significant impact on many inversion transactions, they would also have broad and substantial application beyond the inversion context and are discussed in our companion client memorandum, **Treasury Proposes Overhaul of Intercompany Debt Rules**.

- Addition of a rule, applicable where the U.S. target in an inversion was previously distributed in a tax-free transaction, which deems the U.S. target to have made a distribution equal to the value of the distributing company if the value of the stock of the U.S. target at the time of the distribution represented more than 50% of the value of the stock of the distributing company.
- Addition of a rule providing that, in computing the inversion ownership fraction, shareholders of the U.S. target are treated as receiving additional shares of the foreign acquirer in exchange for the full amount of distributions that are "added back," even if the actual consideration paid by the foreign acquirer in exchange for the U.S. target consists of stock and cash.

Prior Acquisition Rule

The New Inversion Regulations include a rule, not announced in the Notices, that targets foreign acquirers whose size has increased as a result of acquiring other U.S. companies for stock consideration (or stock and cash). For purposes of determining the inversion ownership fraction, the rule excludes from the denominator shares of the foreign acquirer (or a predecessor) issued to former shareholders of previously acquired U.S. companies during the 36 months preceding the signing date of the relevant inversion transaction. Computational adjustments are made for redemptions and stock splits that occur between a prior acquisition and the relevant inversion.

- This portion of the New Inversion Regulations was not previewed in the Notices and appears to have been targeted *ad hoc* at a particular transaction that had been structured to comply with the Notices and was the subject of a binding agreement. The rule is effective for inversions that close on or after April 4, 2016, even if there was a binding agreement to effect the inversion prior to that date and even if the prior U.S. acquisition(s) occurred before that date. This lack of any grandfathering is disappointing and illustrates yet another political risk associated with cross-border M&A activity involving U.S. corporations.
- The 36-month period is a bright-line rule—whether the foreign company had any plan to increase its size in order to pursue a larger inversion is irrelevant to the analysis.
- The new rule generally applies whenever a foreign company previously acquired a U.S. company in exchange for stock (or stock and cash) during the 36-month period, even if the previously acquired U.S. company was small in relation to the foreign acquirer and thus did not resemble what is typically thought of as an inversion. Accordingly, the new rule is not limited to so-called "serial inverters." However, under what is truly a *de minimis* exception, the new rule does not apply if the former shareholders of an acquired U.S. company receive stock that amounts to less than 5% (by vote and value) of the foreign acquirer and is worth less than $50 million at the time of the prior acquisition.
    - *Trap for the Unwary.* Stock issued by a foreign acquirer in what might otherwise be considered as a commercial matter a "cash acquisition" of a U.S. target would appear to count as "bad" for these purposes. Thus, for example, rollover equity (including options) issued to management in a cash acquisition would appear to be excluded from the denominator for purposes of this regulation, unless the total amount of equity issued satisfies the *de minimis* exception.

Non-Ordinary Course Distribution Rule

The New Inversion Regulations implement a provision in the 2014 Notice targeting inversion transactions where the U.S. target, prior to the transaction, made distributions of property to its shareholders, thereby decreasing its value and reducing the inversion ownership fraction. In calculating the inversion ownership

fraction, this rule deems former shareholders of the U.S. target to receive additional shares of the foreign acquirer equal to the value of "non-ordinary course distributions," including stock buybacks and stock distributed to shareholders in spin-off transactions ("**NOCDs**") made by the U.S. target during the 36-month period ending on the acquisition date. As previewed in the 2014 Notice, this rule applies without regard to whether the NOCD was part of a plan related to the inversion.

Additional NOCD rules include:

- A rule that provides that the value of a distribution is determined on the distribution date, such that post-distribution fluctuations in the value of the stock of the distributing company or the value of the distributed property are irrelevant.
- A rule that provides that a U.S. target must take into account distributions made by a "predecessor" for purposes of calculating the NOCDs made by the U.S. target. The New Inversion Regulations define "predecessor" broadly to include any entity acquired by the U.S. target in a transaction in which the former shareholders of the acquired entity receive 10% or more of the U.S. target's stock in the transaction. The New Inversion Regulations also provide that consideration paid to former shareholders of the predecessor entity in the acquisition will be treated as NOCDs if it is provided by the acquired entity (*e.g.,* in a leveraged buyout) and not the U.S. target as buyer.
- A rule applicable where (i) a U.S. company (the distributing company) distributes the stock of another U.S. company (the controlled company) in a Section 355 transaction, (ii) the value of the stock of the controlled company represents more than 50% of the value of the stock of the distributing company immediately before the distribution, and (iii) thereafter the controlled company is acquired by a foreign company. In this circumstance, the controlled company is treated for purposes of the NOCD rules as having made a distribution equal to the value of the stock of the distributing company (but not taking into account the value of the controlled company).

In the 2014 Notice, the Treasury Department indicated that distributions covered by the NOCD rules would include money or other property transferred to the U.S. target's shareholders in the inversion transaction to the extent that the money or other property was "directly or indirectly" provided by the U.S. target. Notably, despite requests for specific guidance on this rule from commentators, the New Inversion Regulations provide no guidance on when consideration is "directly or indirectly" provided by the U.S. target. Thus, we believe taxpayers will be well served to continue to structure any inversion acquisition financing without direct or indirect credit support from the U.S. target (*e.g.*, no upstream guarantees or pledges).

The NOCD rules described above also apply for purposes of the inversion rules in Section 367, which generally impose tax on the shareholders of the U.S. target where the U.S. target is larger than the foreign acquirer. For purposes of Section 367, the NOCD rules have the effect of increasing the value of the U.S. target in relation to the foreign acquirer.

Other Rules

Other revisions to the rules announced in the Notices include:

- Addition of a *de minimis* exception that turns off the application of the previously announced "cash-box rule" if the former shareholders of a U.S. target receive stock that amounts to less than 5% (by vote and value) of the foreign acquirer. The "cash-box rule" excludes shares of the foreign acquirer when calculating the inversion ownership fraction that are attributable to passive assets if 50% or more of the foreign acquirer's assets (including assets held by members of its group) are passive.

- Addition of a new anti-abuse rule for multi-step acquisitions that treats a foreign company's acquisition of another foreign company as subject to the inversion rules where the foreign target previously acquired a U.S. target, and both acquisitions are part of a plan (or a series of related transactions) to avoid the application of Section 7874 to the acquisition of the U.S. target. This anti-abuse rule is aimed at transactions that use multiple steps to avoid the application of the "third-country rule" or to meet the "substantial business activities test," as the rule requires the transaction to be tested by reference to the jurisdiction of the ultimate foreign acquirer.
- Implementation of the previously announced rule that prevents "hopscotch" loans from facilitating tax-free access to cash trapped in foreign subsidiaries of the U.S. target, with new exclusions for certain ordinary course transactions, *e.g.*, for obligations (including sale and repurchase transactions) that are fully collateralized by marketable securities posted to or received by a commodities or securities dealer acting in the ordinary course of its business.
- Implementation of the previously announced rules limiting "de-control" of a controlled foreign subsidiary (which would facilitate tax-free access to its earnings) with no exceptions for business integrations, which may place limitations on an inverted company's ability to integrate its combined businesses, *e.g.*, where there are redundant or overlapping legal entities.
- Provision for the full or partial unwind of the effect of the rules preventing "de-control" of a controlled foreign subsidiary in certain circumstances, *e.g.*, where the stock issued or transferred to achieve a "de-control" is later transferred to a third party.
- Implementation of the previously announced "stock-dilution rule" that requires an inverted U.S. company to pay U.S. income tax upon certain transactions that dilute the U.S. company's ownership interest in a controlled foreign subsidiary.
- Addition of a new "asset-dilution rule" that requires a controlled foreign subsidiary of an inverted U.S. company to recognize built-in gain upon the transfer of assets to another foreign corporation in a transaction that would otherwise be tax-free, subject to certain exceptions. This rule is designed to prevent controlled foreign subsidiaries from moving assets outside of the U.S. taxing jurisdiction.

Effective Date

The regulations do not have a uniform effective date. In general, the effective date for each provision corresponds to when (or whether) it was previewed in one of the Notices. Regulations implementing the 2014 Notice generally apply to transactions that close on or after September 22, 2014. Regulations implementing the 2015 Notice generally apply to transactions that close on or after November 19, 2015. New rules that were not announced in either Notice are generally effective for transactions that close on or after April 4, 2016. In certain cases where a rule previously announced in a Notice was modified by the regulations but is effective for a period prior to April 4, 2016, a taxpayer may elect to apply the version of the rule as it appeared in the relevant Notice for a transaction occurring prior to April 4, 2016. Additionally, a taxpayer may elect to apply certain provisions with later effective dates to earlier time periods, back to September 22, 2014.

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