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Treasury Department Seeks to Curb Inversion Transactions

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday October 1, 2014

Editor's Note: The following post comes to us from Jodi J. Schwartz, partner in the Tax Department at Wachtell, Lipton, Rosen & Katz, and is based on a Wachtell Lipton memorandum by Ms. Schwartz and Michael Sabbah.

Yesterday [September 22, 2014], the Treasury Department and the IRS announced their intention to issue regulations (the "Regulations") to limit the economic benefits of so-called "inversion" transactions in the absence of Congressional action. The Regulations, once issued, will generally apply to transactions completed on or after September 22, 2014. (Notice 2014-52, Rules Regarding Inversions and Related Transactions.)

Following the change in U.S. law in 2004 that prevented a U.S. company from inverting simply by re-incorporating in a foreign jurisdiction, but instead required a combination of a U.S. corporation with a foreign partner, typical inversion transactions have generally involved such a combination in which a foreign corporation becomes the new parent of the combined group. In general, as long as shareholders of the foreign corporation own more than 20% of the combined entity, the punitive aspects of existing anti-inversion legislation do not apply. Treasury's new Regulations will significantly affect inversions in three major respects: first, the inverted group's ability to access low-taxed earnings of foreign affiliates through intercompany loans—which is often a major and up-front benefit of inversions—will be substantially curtailed; second, the rules measuring whether an 80% inversion has occurred will be tightened; and, finally, the Treasury announcement states that further guidance should be expected limiting the ability of inverted groups to reduce their U.S. tax liability by stripping future earnings out of the U.S.

Under the Regulations, loans by foreign subsidiaries of the U.S. group to the new foreign parent (so-called "hopscotch loans") will generally be treated as a taxable dividend to the former U.S. parent corporation, thus limiting the ability to access cash held by such foreign subsidiaries without incurring U.S. tax. In addition, transactions designed to "de-control" foreign subsidiaries from their U.S. parent (in order to remove such subsidiaries' foreign earnings from U.S. taxation) will be also targeted by the Regulations.

Certain non-ordinary course distributions made by the U.S. corporation in the 3-year period preceding the transaction that reduced the size of the U.S. corporation will be disregarded for purposes of determining whether the 80% ownership test is satisfied. As well, taxpayers will no longer be able to avail themselves of “diet” dividends as a means of shrinking the size of a U.S. corporation in order to avoid shareholder gain. Finally, the Regulations will prevent foreign companies with excessive amounts of cash or other passive assets from serving as merger partners in an inversion.

One area with respect to which regulatory action has been widely expected was not directly addressed by yesterday’s announcement. Specifically, the announcement does not propose changes to the tax rules affecting deductible interest payments from the U.S. group to the new foreign parent. It indicates, however, that the Treasury Department and IRS are considering guidance to address those issues that would, to the extent applicable to inverted groups, apply to groups that complete inversion transactions on or after September 22, 2014.

It remains to be seen whether these changes, if they slow the pace of inversion transactions, will increase the pressure for reform that squares the circle of a U.S. tax system with relatively high corporate tax rates and essentially permanent deferral of offshore earnings.