Further Treasury Action to Limit “Inversions”

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Yesterday, the Treasury Department and the IRS announced their intention to issue regulations that would make it harder for U.S. companies to invert and would further reduce the economic benefits from inversions (Notice 2015-79, Further Rules Regarding Inversions and Related Transactions) (the “Notice”). The Notice targets transactions in which a U.S. company combines with a smaller foreign company and the former shareholders of the U.S. company own at least 60% of the combined enterprise. Transactions that do not meet this 60% threshold are generally not affected by the Notice. This latest administrative attempt to curb inversions follows last year’s Notice 2014-52, which made it more difficult and less advantageous to invert by, among other things, restricting inverted companies’ ability to access cash held by foreign subsidiaries of the former U.S. group (see our prior memo). Despite widespread anticipation to the contrary, yesterday’s Notice did not directly address “earnings stripping”, the shifting of U.S. source income to lower-tax jurisdictions through deductible intercompany payments. Rather, the Notice reiterates that Treasury and the IRS continue to consider guidance to address this issue.

Yesterday’s Notice limits the ability to invert in situations in which a U.S. company combines with a smaller foreign company under a new holding company that is tax resident in a third jurisdiction (i.e., a jurisdiction other than that in which the foreign merger party is tax resident), where the former shareholders of the U.S. company own at least 60% of the combined enterprise. Selecting an appropriate holding company jurisdiction in a cross-border business combination transaction typically involves a delicate balancing of many factors, including corporate governance, take-over defenses, stock exchange listing and disclosure requirements, executive compensation, as well as U.S. and foreign taxes. The approach taken by the Notice, which appears to be based on the assumption that use of a third-country holding company invariably is motivated by a desire to erode the U.S. tax base, could limit the ability of parties to certain cross-border business combinations to select a holding company jurisdiction that is optimal for non-tax reasons.

The Notice also increases the U.S. tax cost of certain restructuring transactions intended to move foreign operations “out from under” the U.S. company following an inversion that meets the 60% threshold. The Notice generally provides for U.S. tax on certain post-inversion intercompany transfers by foreign subsidiaries of the U.S. company and on certain post-inversion intercompany transfers of stock in such foreign subsidiaries. In addition, the Notice promises regulations that would modify the “substantial business activities” exception, clarify the “anti-stuffing rules,” and make certain technical corrections to rules described in last year’s guidance. The regulations contemplated by the Notice would generally apply to transactions completed on or after November 19, 2015.

1This memo was originally released November 20, 2015.
Yesterday’s announcement acknowledges that Treasury cannot stop inversions without new statutory authority. One may debate whether the goal of U.S. tax policy should be stopping inversions or rather fundamental reform. What remains clear is that as long as the U.S. tax system is characterized by relatively high corporate tax rates and essentially permanent deferral of offshore earnings, U.S. companies will have an incentive to pursue transactions that result in more non-U.S. income and less U.S. tax.

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