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# The Government Strikes Back - New IRS Notice Strengthens Anti-Inversion Rules

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# [The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules](#)

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## Reporter

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## Highlight

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Inversion or expatriation transactions are often prompted by financial institutions, such as private equity owners and hedge funds that own or control companies in which they have invested and that desire to reduce U.S. corporate taxes they must pay. This article explains the basic steps and perceived tax benefits to U.S. corporations engaging in inversion transactions, and describes both the current statutory limitations contained in the Internal Revenue Code to prevent such inversions and a recently announced Internal Revenue Service (IRS) plan to make inversions more difficult to achieve. Finally, the article discusses the appropriateness of the new IRS plans and suggests other ways to make such inversions less attractive.

## Text

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Corporate inversions, or tax expatriations, are a decades-old tax reduction technique used by U.S.-based multinational corporations, financial institutions, private equity companies, and foreign-based hedge funds that own or control U.S.-based multinational companies. Genuine cross-border mergers benefit the U.S. economy by enabling U.S. companies to invest overseas and by encouraging foreign investment to flow into the U.S. <sup>1</sup> However, the law requires that these transactions be motivated by genuine business strategies and not just by a desire to avoid U.S. taxes by shifting the tax residence of the parent entity to a low-tax jurisdiction. In 2013 and 2014 a number of major U.S. corporations disclosed plans to expatriate themselves, including Actavis, <sup>2</sup> Liberty Global, <sup>3</sup> Chiquita Brands, <sup>4</sup> Applied Materials, <sup>5</sup> Abbvie, <sup>6</sup> Pfizer, <sup>7</sup>

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<sup>1</sup> U.S. Dept. of the Treasury, "Fact Sheet: Treasury Actions to Rein in Corporate Transactions," (Press release, Sept. 22, 2014), available at <http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx> ; Notice 2014-52, 2014-42 IRB 712 (09/23/2014).

<sup>2</sup> Drew Armstrong, "Actavis Lowers Tax Rate to 17% After Warner Chilcott Deal" (Bloomberg, Dec. 19, 2014), available at <http://www.bloomberg.com/news/2013-05-21/actavis-lowers-tax-rate-to-17-after-warner-chilcott-deal.html>.

<sup>3</sup> Jesse Drucker, "Maine's Largest Landowner, Billionaire Media Magnate Avoids Millions in Taxes With Inversion Deal" (Bangor Daily News, Dec. 19, 2014), available at <http://bangordailynews.com/2014/11/03/business/maines-largest-landowner-billionaire-media-magnate-avoids-millions-in-taxes-with-inversion-deal/>.

<sup>4</sup> Alexander C. Kaufman, "Obama's Inversion Crackdown Not Enough to Keep Chiquita in America" (Huffington Post, Dec. 19, 2014), available at [http://www.huffingtonpost.com/2014/10/22/chiquita-tax-inversion\\_n\\_6022874.html](http://www.huffingtonpost.com/2014/10/22/chiquita-tax-inversion_n_6022874.html).

<sup>5</sup> David Gelles, "New Corporate Tax Shelter: A Merger Abroad" (New York Times DealBook, Dec. 19, 2014), available at <http://dealbook.nytimes.com/2013/10/08/to-cut-corporate-taxes-a-merger-abroad-and-a-new-home/>.

<sup>6</sup> Matthew Campbell & David Welch, "Shire Holding Takeover Talks With Abbvie" (Bloomberg, Dec. 19, 2014), available at <http://www.bloomberg.com/news/2014-07-11/shire-said-to-hold-takeover-talks-with-abbvie.html>.

<sup>7</sup> Victor Fleischer, "How Tax Laws Distort the Pfizer Deal" (New York Times DealBook, Dec. 19, 2014), available at [http://dealbook.nytimes.com/2014/04/29/how-tax-laws-distort-the-pfizer-deal/?\\_r=1](http://dealbook.nytimes.com/2014/04/29/how-tax-laws-distort-the-pfizer-deal/?_r=1).

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

Medtronic,<sup>8</sup> Mylan,<sup>9</sup> and Burger King.<sup>10</sup> These proposed expatriations caused the U.S. government to respond. On September 22, 2014, the Treasury Department announced that it intended to take action "to reduce the tax benefits of--and when possible, stop--corporate tax inversions."<sup>11</sup> This action is expected to "significantly diminish the ability of inverted companies to escape U.S. taxation," and for some companies considering such a merger "the action will mean that inversions no longer make economic sense."<sup>12</sup> This article examines (1) statutory limitations on corporate inversions; (2) the principal elements of Treasury's new line of attack; and (3) the appropriateness of the new initiative.

Before turning to the technical analysis of the current law and Treasury's actions, it may be useful to consider why corporate inversions provoke controversy. When an individual expatriates, she is deemed to have sold all of her assets at fair market value and is taxed on the deemed gain.<sup>13</sup> In a corporate expatriation, however, nothing physically moves from the U.S. to the foreign country. The company's physical plants and facilities, bank accounts, employees, and executives generally remain in exactly the same place where they were before the inversion. In essence, the inversion simply occurs on paper--and the maneuver fails to yield any demonstrable economic benefit to the United States. Rather, there is a loss of revenue to the Treasury. Some people say this is unpatriotic.<sup>14</sup> However, in response, tax lawyers often quote Judge Learned Hand: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."<sup>15</sup> The real question has nothing to do with patriotism. It is whether the corporate inversion strategy is a legal tax avoidance technique and, if so, whether it ought to be either modified or abolished.

### TECHNICAL ANALYSIS OF INVERSION

**Basic Structure.** An inversion is a transaction where a U.S. corporation transfers its stock or assets and thereby becomes a subsidiary of an entity located in a foreign jurisdiction (either directly or indirectly). As a result, the U.S. parent of a multinational corporation is replaced with a foreign parent corporation. There are two general types of inversions. The first type, a single company inversion, is generally not advantageous under current law. (The Helen of Troy inversion, illustrated later, is an example of a single company inversion.) The second type, a foreign acquisition inversion (illustrated in Figure 1), occurs when a U.S. corporate parent and a foreign corporation are combined, resulting in a group with a foreign parent corporation.

**Tax Benefits.** Inversions have several tax benefits:

1. The non-U.S. income of foreign subsidiaries is generally not subject to U.S. tax when earned;
2. The non-U.S. income of foreign subsidiaries is generally not subject to any tax upon remittance of earnings to the new foreign parent; and
3. There are opportunities to reduce U.S. taxable income through deductible payments made by U.S. subsidiaries to the new

<sup>8</sup> Howard Gleckman, "The Tax-Shopping Backstory of the Medtronic-Covidien Inversion" (Forbes, Dec. 19), available at <http://www.forbes.com/sites/beltway/2014/06/17/the-tax-shopping-backstory-of-the-medtronic-covidien-inversion/>.

<sup>9</sup> Chad Bray, "Mylan to Buy Abbott's Generic Drug Business Outside U.S. for \$ 5.3 Billion" (New York Times DealBook, Dec. 19, 2014), available at <http://dealbook.nytimes.com/2014/07/14/mylan-to-buy-generics-drugs-business-outside-u-s-from-abbott-for-5-3-billion/>.

<sup>11</sup> U.S. Dep't of the Treasury, "Treasury Announces First Steps to Reduce Tax Benefits of Corporate Inversions" (Press release, Sept. 22, 2014), available at <http://www.treasury.gov/press-center/press-releases/Pages/jl2647.aspx>.

<sup>12</sup> Id.

<sup>13</sup> See IRC § 877A. All section references contained here are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations Promulgated thereunder. See also Internal Revenue Service Publication 519, U.S. Tax Guide for Aliens, at 24 ("In the year you expatriate, you are subject to income tax on the net unrealized gain (or loss) in your property as if the property had been sold for its fair market value on the day before your expatriation date.")

<sup>14</sup> Howard Gleckman, "Are Tax Inversions Really Unpatriotic?" (Forbes, July 29, 2014), available at <http://www.forbes.com/sites/beltway/2014/07/29/are-tax-inversions-really-unpatriotic/>.

<sup>15</sup> [Helvering v. Gregory 69 F.2d 809, 810](#) (2 nd Cir 1934), aff'd [293 U.S. 465 \(1935\)](#).

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

foreign parent (these are subject to limitations).<sup>16</sup>

These tax benefits are illustrated in Figure 1. For example, one U.S. company believed its inversion would reduce its effective tax rate from 32 percent to between 20 percent and 25 percent--which would add approximately 58 cents per share to its earnings. Another U.S. company expected to increase net earnings by \$ 40 million per year following its inversion, and a third U.S. company reportedly would have saved \$ 1 billion in taxes each year had its proposed merger with the other company been completed successfully.

**Examples of Recent and Proposed Inversion Transactions.** Figure 2 diagrams the Helen of Troy single-company inversion mentioned above, which was completed in 1993, well before the current round of transactions. Figures 3 and 4 diagram two more recent proposed inversions.

[SEE Figure 1: Tax Benefits IN ORIGINAL]

[SEE Figure 2: Helen of Troy Inversion IN ORIGINAL]

[SEE Figure 3: Proposed Inversion A IN ORIGINAL]

### EXISTING TAX CODE LIMITATIONS ON INVERSIONS

**Historic Section 367 Limitations.** Pursuant to Section 367, transfers of stock or securities of a domestic corporation<sup>17</sup> abroad are subject to U.S. tax unless (1) U.S. shareholders receive less than 50 percent of the foreign acquiring corporation (by vote and value); (2) U.S. officers, directors, and 5 percent shareholders of the U.S. target corporation own less than 50 percent of the foreign acquiring corporation (FAC) (by vote and value); (3) either (a) the U.S. person is not a 5 percent transferee shareholder or (b) the U.S. person is a 5 percent or greater transferee shareholder and enters into a five-year gain recognition agreement; or (4) the "active trade or business test" is satisfied.<sup>18</sup>

The active trade or business test requires that:

. Either the transferee foreign corporation or any qualified subsidiary or partnership be engaged in an active trade or business outside the U.S. for the three years preceding the transfer; and

. There is no plan to substantially dispose of or discontinue such trade or business at the time of the transfer.<sup>19</sup>

[SEE Figure 4: Proposed Inversion B IN ORIGINAL]

In addition, the trade or business of the foreign corporation must be at least equal (in fair market value terms) to that of the U.S. target.<sup>20</sup> The restrictions imposed by Section 367 are longstanding.

**Section 7874 Limitation.** A wave of corporate inversions in the 1990s led to a call, similar to the current desire, to stem the flow of inversions. Section 7874 was enacted in response. Section 7874 applies if (1) a FAC acquires (directly or indirectly) substantially all of the assets held (directly or indirectly) by a domestic corporation (the "Acquisition Test"), and (2) after the acquisition, at least 60 percent (or, for certain purposes, 80 percent) of the stock (by vote or value) of the FAC is held by former shareholders of the domestic corporation (the "Ownership Test").<sup>21</sup>

<sup>16</sup> See IRC §§ 163(j), 267, 482.

<sup>17</sup> A "domestic" corporation or partnership is defined in IRC § 7701(a)(4) as a corporation, or a partnership organized or created under the law of the United States or any of its States.

<sup>18</sup> [26 U.S.C. § 367](#) (2012).

<sup>19</sup> Treas. Reg. § 1.367(a)-(3).

<sup>20</sup> Treas. Reg. § 1.367(a)-(3)(c). 22 Id.

<sup>21</sup> [26 U.S.C. § 7874](#) (2012).

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

**Acquisition Test.** The Acquisition Test requires that the FAC must complete the direct or indirect acquisition of "substantially all" of the assets held by a domestic corporation or that constitute the trade or business of a domestic partnership.<sup>22</sup> Indirect acquisitions generally refer to an acquisition by the FAC of stock of a domestic corporation or partnership interests of a domestic partnership (considered an acquisition of a proportionate amount of such corporation's or partnership's assets). An acquisition by the FAC of a partnership interest in any partnership (foreign or domestic) that holds stock of a domestic corporation is considered an indirect acquisition of the proportionate amount of properties held by the domestic corporation. However, an acquisition by the FAC of stock of a second foreign corporation that owns (directly or indirectly) a domestic corporation or partnership does not constitute an indirect acquisition of the properties held by the domestic entity. The Ownership Test is usually represented as a fraction:

FAC stock held by former shareholders/total FAC stock

There are two potential traps:

. Disqualified stock: Stock of the foreign acquiring corporation issued in a transaction related to the acquisition but in exchange for nonqualified property (cash, marketable securities, etc.) is not included in the denominator of the fraction.<sup>23</sup>

. Purchase of domestic corporation with a management rollover: Stock issued by the FAC for cash would be excluded from the denominator as noted above. But, if a few shares of the FAC were issued to management, such shares would be the only shares counted in both numerator and denominator. Thus it could fail the ownership test. There is however, a de minimis exception--if former shareholders of the U.S. corporation own less than 5 percent (by vote and value) of the FAC and, after the transaction, own less than 5 percent of the expanded affiliated group (EAG), such stock is excluded from both the numerator and the denominator.<sup>24</sup> Claims on equity (e.g., options, warrants, convertible debt instruments, etc.) may be added to the existing stock of the FAC. In general, internal restructurings are protected from application of Section 7874.

**Active Trade or Business Test.** After the acquisition, the EAG that includes the FAC is tested to determine if it has substantial business activities in the foreign country in which it is organized, when compared to the total business activities (the "Business Activities Test"). The EAG comprises an affiliated group with the stock ownership connection and includes foreign corporations. The EAG will have substantial business activities in the country of organization of the FAC only if a 25 percent threshold is met with regard to each of three tests:

1. Group employees test, measured either by the headcount test or the compensation test;
2. Group assets test; and
3. Group income test.

Advocates of corporate inversions have harshly criticized the Business Activities Test and it is generally noted that many multinational companies would not satisfy the 25 percent threshold anywhere in the world.<sup>25</sup>

**Consequences.** Most recent inversions fall within this 60 percent to 80 percent range, which leads to the following outcomes:

. 80 Percent Inversion: If, under the Ownership Test, the former shareholders of the acquired domestic entity hold at least 80 percent of the FAC, then the FAC is treated as a domestic corporation for all tax purposes. Thus, there is no benefit derived from the inversion.

. 60 Percent Inversion: If, under the Ownership Test, the former shareholders of the acquired domestic entity hold at least 60 percent of the foreign acquiring corporation (but less than 80 percent), then foreign acquiring entity is respected as a

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<sup>22</sup> Id.

<sup>23</sup> Treas. Reg. § 1.7874-4T.

<sup>24</sup> Id.

<sup>25</sup> Treas. Reg. § 1.7874-3T.

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

foreign corporation, but (1) the domestic corporation is limited in its ability to use tax attributes, such as NOLs, and (2) Section 4985 imposes a 15 percent excise tax on certain equity based compensation of "insiders."

### [IRS NOTICE 2014-52](#)

**Overview.** On September 23, 2014, the IRS and Treasury issued [Notice 2014-52](#) (the "Notice"),<sup>26</sup> which applies to transactions completed on or after that date. As stated in the Notice, Treasury and the IRS intend to issue regulations under Sections 304(b)(5)(B), 367, 956(e), 7701(l), and 7874 to address transactions that are structured to avoid the purposes of Sections 367 and 7874. These regulations will:

- . Make it more difficult for U.S. entities to invert by strengthening the requirement that former owners of the U.S. entity own less than 80 percent of the new combined entity;
- . Prevent inverted companies from accessing a foreign subsidiary's earnings while deferring U.S. tax through the use of creative loans (so-called "hopscotch" loans);
- . Prevent inverted companies from restructuring a foreign subsidiary in order to access that subsidiary's earnings tax-free; and
- . Prevent inverted companies from transferring cash or property from a CFC to a new parent to completely avoid U.S. income tax.

The Notice makes revisions to the Ownership Test as follows: Under current law, per Section 7874 if, pursuant to the Ownership Test, former shareholders of the domestic corporation own more than 80 percent of the FAC, the FAC is treated as a domestic corporation for all purposes of the Code. Under the Notice, new regulations are expected to be issued that exclude certain stock of a FAC from the denominator. Figure 5 illustrates this expected new rule: First, if more than 50 percent of the gross value of all "foreign group property" constitutes "foreign group nonqualified property," a portion of the stock of the FAC will be disregarded. Foreign group property means any property, including property that gives rise to disqualified stock under Treasury Regulation Section 1.7874-4T. Foreign group nonqualified property generally means (1) cash or cash equivalents, (2) marketable securities, and (3) obligations owed by related parties.<sup>27</sup> To avoid double counting, property acquired by the foreign acquiring corporation in exchange for disqualified stock (which is excluded from the denominator of the ownership fraction), will also be excluded.

**"Skinnying Down" Distributions.** As stated above, if Section 7874 applies and if former shareholders of the domestic corporation own at least 80 percent of the FAC, then the FAC is treated as a U.S. corporation for all purposes of the Code. In order to reduce the ownership fraction, domestic corporations have distributed property to former shareholders (called "skinnying down"). Similarly, domestic corporations have distributed property to satisfy the substantiality test of Section 367. The Notice provides that Regulations are expected to be issued to disregard nonordinary course distributions of property or liabilities made during the 36-month period ending on the acquisition date. Non-ordinary course distributions mean the excess of all distributions made during a taxable year over 110 percent of the average of such distributions during the prior 36-month period. This will include any distribution in redemption of stock.

[SEE Figure 5: [Notice 2014-52](#)--Strengthens 80 Percent Requirement IN ORIGINAL]

Under Section 7874(c)(2)(A), stock of the foreign acquiring corporation held by members of the EAG is not included. Regulations excluded internal group restructurings and loss of control transactions from this rule.<sup>28</sup> If these exceptions apply, stock of the foreign acquiring corporation held by the EAG is excluded from the numerator but included in the denominator. Regulations are expected to be issued that provide that if stock of the foreign acquiring corporation is received by a former corporate shareholder of the domestic entity, and that stock is subsequently transferred, the transferred stock is not treated as being held by a member of the EAG for purposes of applying the EAG rules. There will be two exceptions for subsequent transfers within the group as illustrated in Figures 6 and 7.

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<sup>26</sup> [2014-42 IRB 712](#) (09/23/2014).

<sup>27</sup> See Treas. Reg. § 1.7874-4T(i)(7).

<sup>28</sup> Treas. Reg. § 1.7874-1.

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

**The Anti-Hopscotch Rule.** Under current law, U.S. multinationals owe U.S. tax on the profits of their controlled foreign corporations (CFCs) although they are generally not subject to pay this tax until those profits are repatriated or if the CFC is sold (that is, paid to the U.S. parent firm as a dividend). Profits that have not yet been repatriated are known as deferred earnings. If the CFC attempts to avoid this dividend tax by investing in certain U.S. property--such as by making a loan to, or investing in stock of its U.S. parent or one of its domestic affiliates--the U.S. parent is treated as if it received a taxable distribution from the CFC.<sup>29</sup> However, some inverted companies have the CFC make the loan to the new foreign parent, instead of to its U.S. parent, and take the position that this rule does not apply. This "hopscotch" loan is not currently considered U.S. property and is therefore not taxed as a deemed dividend. The Notice removes the benefits of these hopscotch loans by providing that such loans are considered "U.S. property" for purposes of applying the anti-avoidance rule. Under the Notice the same dividend rules would now apply as if the CFC had made a loan to the U.S. parent.

**De-controlling Strategy Closed Down by Applying Look-Through Rules.** After an inversion, some U.S. multinationals avoid ever paying U.S. tax on the deferred earnings of their CFC by having the new foreign parent buy enough stock to take control of the CFC away from the former U.S. parent. This "de-controlling" strategy is used to allow the new foreign parent to access the deferred earnings of the CFC without ever paying U.S. tax on them. Under the Notice, the new foreign parent would be treated as acquiring additional stock in the former U.S. parent, rather than the CFC, to remove the benefits of the "de-controlling" strategy. The CFC would remain a CFC and would continue to be subject to U.S. tax on its profits and deferred earnings.

Figures 8 and 9 illustrate the actions proposed by the Notice.

### IMPACT ON U.S. SHAREHOLDERS

As stated above, the focus of the press reports has been to emphasize how U.S. corporations are reducing taxes by expatriating. However, the press reports have ignored the effect of an inversion where 60 percent to 79 percent of the historic shareholders are U.S. taxpayers and now own the stock of the FAC. In that situation, the U.S. shareholders will be deemed to have sold their stock and will owe tax on the gain. If they do not dispose of the stock of the new FAC these shareholders will have "phantom income," i.e., taxable income without the cash to pay the tax. The shareholders have a tough choice: either (1) hold the stock, pay the tax on phantom income, and get to participate in potential future growth of the FAC; or (2) sell the stock of the FAC so that there is cash to pay the tax on the deemed gain resulting from the transfer to the FAC, but lose any potential growth.

### CONCLUSION

The answer to the question raised at the beginning of this article--whether the corporate inversion strategy should be modified or abolished--is that the corporate inversions or expatriations ought to be abolished. Such transactions provide no benefit to the U.S. economy, can adversely affect U.S. shareholders, and result in a significant loss of revenue to the U.S. However, until Congress enacts legislation abolishing these transactions, they should be restricted as much as possible.

Treasury has taken the initial steps to attempt to reduce corporate expatriations but it needs to do more. It intends to issue regulations that will strengthen the earnings-stripping provisions so as to make it more difficult for the U.S. corporation to pay deductible interest to the FAC. It also needs to consider whether to issue regulations under Section 385 to treat the payment of the deductible interest on debt issued to the FAC as non-deductible dividends. One of the issues that will need to be confronted is whether any such new rules will be specifically targeted to inverted companies. From a policy perspective, specific targeting may be more difficult to defend.

[SEE Figure 6: [Notice 2014-52](#)--Internal Restructuring Group Exception IN ORIGINAL]

[SEE Figure 7: [Notice 2014-52](#)--"Spinversion" Example IN ORIGINAL]

[SEE Figure 8: [Notice 2014-52](#)--Examples IN ORIGINAL]

[SEE Figure 9: [Notice 2014-52](#)--Prevent Removal of Untaxed Foreign Earnings IN ORIGINAL]

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<sup>29</sup> IRC § 956.

## The Government Strikes Back--New IRS Notice Strengthens Anti-Inversion Rules

Finally, Congress needs to consider whether continuing to adhere to the bedrock principle of the U.S. tax system that domestic corporations are taxable on their worldwide income is in the best interest of our country. Based upon the increase in inversion transactions, which involve elaborate and expensive corporate tax planning to reduce a U.S. corporation's tax bill, perhaps it is finally time for an overhaul of our worldwide system of taxation on U.S. corporations. Since, as stated above, it is generally the U.S. shareholders that ultimately bear the burden of the tax in an inversion, perhaps a solution would be to make the corporation liable for the shareholder tax.

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