Cravath, Swaine & Moore LLP

Michael L. Schler
+1-212-474-1588
mschler@cravath.com

New Tax Restrictions on Inversions

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On September 22, 2014, the Treasury Department and IRS issued Notice 2014-52 (the "Notice"), relating to inversions.

SUMMARY

The Notice:

- preserves the basic structure of inversion transactions;
- eliminates some of the planning techniques used to avoid the 60% and 80% tests under the inversion rules (described below);
- imposes a new calculation that will in some cases make it more difficult to satisfy the 60% and 80% tests even in the absence of pre-transaction planning;
- following a successful inversion that does not satisfy the 60% test, makes it difficult or impossible to utilize the "trapped cash" held in foreign subsidiaries of the U.S. corporation; and
- threatens the possibility of future restrictions on the use of leverage to reduce future U.S. tax (so-called "earnings stripping").

EFFECTIVE DATE

- The rules in the Notice are effective for any transaction closing on or after September 22, 2014, regardless of whether the deal was announced or signed before that date.
- The same effective date might apply to future restrictions on earnings stripping, or to other future rules designed to prevent the avoidance of the purpose of the existing restrictions on inversions.
- There is no effect on deals already closed, in contrast to some of the legislation that has been proposed.

BASIC STRUCTURE OF INVERSIONS

In an inversion, generally a newly formed foreign corporation ("Foreign Newco") acquires both the inverting U.S. corporation ("US Target") and a smaller foreign corporation ("Foreign Target").

- For the inversion to work, *i.e.*, for Foreign Newco to be respected as a foreign corporation for U.S. tax purposes, shareholders of US Target must acquire less than 80% of the stock of Foreign Newco (the "80% test", and favorable satisfaction of this condition, "satisfaction of the 80% test").

- Even if this test is satisfied, other restrictions including an excise tax on unvested stock-based compensation apply unless shareholders of US Target acquire less than 60% of Foreign Newco (the "60% test", and favorable satisfaction of this condition, "satisfaction of the 60% test").

- As a practical matter, prior to issuance of the Notice, the only relevant test was the 80% test. Many completed and pending inversions violate the 60% test, with US Target planning around the excise tax or grossing up employees for the excise tax.

The Notice does nothing to change these basic rules, which are built into the statute and could be changed only by legislation rather than by administrative action by Treasury. However, the Notice does impose a significant new penalty if the 60% test is not satisfied, making it more important in many cases to satisfy that test.

CALCULATION OF THE 60% AND 80% TESTS

The larger the size of Foreign Target, and the smaller the size of US Target, the easier it is to satisfy the 60% and 80% tests. Consequently, various techniques have been developed to either increase the size of Foreign Target or reduce the size of US Target. In order to restrict these techniques, the Notice imposes new rules for calculating whether the 60% and 80% tests are satisfied.

The new rules will make it more difficult for those tests to be satisfied in some situations. The first rule below will not adversely affect the typical fact pattern for an inversion. However, the second rule could adversely affect even "plain vanilla" inversions where there is not much margin for satisfaction of the 60% test or the 80% test.

Increasing the size of Foreign Target.

If more than 50% of the value of the gross assets of Foreign Target is "nonqualified property", a proportionate amount of stock of Foreign Newco issued to shareholders of Foreign Target is disregarded.

- Disregarding such stock has the effect of increasing the percentage of stock of Foreign Newco deemed to be issued to shareholders of US Target. This makes it easier to fail the 60% and 80% tests.

- Nonqualified property includes cash and similar assets. It also includes operating assets purchased by Foreign Target with cash in contemplation of the inversion.

- This rule is designed to prevent the creation of a foreign "cash box" that is later used as Foreign Target. These entities have reportedly been set up by certain private equity funds.

- This rule is also aimed at transactions such as the Perrigo/Elan inversion, which closed in December 2013, where Elan (the smaller Irish company) had previously sold many of its assets for cash.

Reducing the size of US Target.

Under the statute, in testing whether the 60% and 80% tests are satisfied, a distribution by US Target is disregarded if a principal purpose was to avoid the purposes of the anti-inversion rules by "slimming down" US Target. The Notice supplements this rule with a mechanical test that disregards all "disqualified distributions" by US Target to its shareholders during the 36 months preceding the closing of the inversion transaction.

- The rules in the statute and the Notice are designed to prevent US Target from reducing the percentage of Foreign Newco stock to be issued to the shareholders of US Target.

- However, under the Notice, the motive for a distribution is irrelevant. The rule applies even if a distribution is factually unconnected to the inversion in any way and occurred before the inversion was even contemplated.

- For this purpose, a distribution includes a dividend, stock redemption, spinoff, and cash paid to US Target shareholders in the inversion itself with funds of US Target.

- The formula for determining disqualified distributions is quite complex. For an inversion on January 1 in year 7, (1) distributions during year 6 are disqualified to the extent they exceed 110% of the average annual distributions during years 3-5, (2) distributions during year 5 are disqualified to the extent they exceed 110% of the average annual distributions during years 2-4, and (3) distributions during year 4 are disqualified to the extent they exceed 110% of the average annual distributions during years 1-3.

- The formula is a one-way ratchet; "cushion" under the formula in any of years 4-6 does not reduce the amount of disqualified distributions in any other year.

- The formula raises additional computational complexities for the typical situation where the closing is not on January 1.

- As a result of this rule, a detailed calculation based on a six-year lookback of distributions, buybacks, etc. will be necessary in every case to determine whether the 60% or 80% test is satisfied, unless the favorable result is so obvious that a detailed calculation is not necessary.

USE OF FOREIGN CASH AFTER AN INVERSION

Today, either before or after an inversion, cash held by a foreign subsidiary ("controlled foreign corporation" or "CFC") of US Target cannot be loaned to US Target without incurring a tax cost. This is referred to as the problem of the "trapped cash".

However, after an inversion, under current law the cash can be loaned to Foreign Newco or any foreign subsidiary of Foreign Newco. The cash can then be used to pay down acquisition debt or can even make its way back to the U.S. group. This gives considerable flexibility in the use of the trapped cash and can be a significant reason for a particular inversion transaction.

The Notice would severely limit this flexibility in any case where the 60% test is not satisfied (*i.e.*, where U.S. shareholders of US Target hold 60% or more of the stock of Foreign Newco after the inversion, taking into account the new calculation rules discussed above).

- Any loan after the inversion by a CFC to Foreign Newco or to any foreign subsidiary of Foreign Newco (but not to another CFC of the US Target) will be deemed to be a taxable dividend to US Target. It does not matter whether the cash is ultimately used in the United States.

- The same rule will apply to any guarantee by the CFC of any debt of Foreign Newco or a foreign subsidiary of Foreign Newco.[1]

- A deemed dividend is also triggered by certain other techniques that would cause the CFC to no longer be a CFC and therefore not be subject to the usual restrictions on CFC loans to US Target.

- As a result, following the Notice, the ability to use trapped cash will likely no longer be a significant rationale for an inversion.

EARNINGS STRIPPING AND FUTURE REGULATIONS

One of the major benefits of an inversion is earnings stripping, namely the ability to increase the leverage of the US Target, generally with intercompany debt. The resulting interest deductions are used to shelter future income of US Target from U.S. tax. The Notice does not do anything to prevent this technique. However:

- The Notice states that the Treasury is considering adopting additional restrictions on the use of leverage in inversion transactions and restrictions on other tax avoidance techniques.

- If any such restriction is limited to inversion transactions rather than applying more generally, the restriction will be effective for transactions closed on or after September 22, 2014.

- There is a question about the Treasury's authority to limit leverage in the absence of a statutory amendment. This is likely the reason that the Notice did not limit leverage. However, Treasury could still issue regulations in the future to limit interest deductions arising from any inversion that closes after September 22, 2014. The validity of any such regulation would be subject to judicial review.

- The Notice is also a warning by Treasury that any other technique to attempt to avoid the restrictions of the inversion rules might be stopped retroactively to September 22, 2014. The Treasury has clear statutory authority to issue retroactive regulations to prevent transactions that are abusive. The Treasury will no doubt be following news reports and SEC filings to learn of any new structures being used by taxpayers.

New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com

[1] This rule will cause a borrowing group that includes an inverted U.S. corporation to want a new provision in its bank loan agreements excluding a CFC of the inverted U.S. corporation from guaranteeing debt of a foreign affiliate borrower.