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CLIENT ALERT

IRS Notice 2014-52 Tightens Inversion Rules and Attacks Post-Inversion Tax Reduction Strategies; Government Contract Rules Remain Unchanged

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On September 22, 2014, the IRS and Treasury issued Notice 2014-52, the much anticipated executive action on so-called "inversion" transactions, in which U.S. companies seek tax advantages by moving their parent corporation overseas without significant changes in ownership. Notice 2014-52 tightens existing rules concerning when a company is treated as inverted and restricts certain tax benefits for inverted companies. Analogous existing rules restricting the ability of inverted corporations to obtain government contracts remain unchanged. Government contractors should continue to monitor developments.

The media coverage of inversions has been strongly negative, prompting action by the Administration. Nevertheless, Treasury does not want to inhibit genuine cross-border mergers or foreign investment in U.S. companies, and taxpayer groups have expressed concern over possible retroactive application of new inversion rules. Treasury took a balanced approach to Notice 2014-52, leaving in place the basic contours of the inversion rules set forth in Section 7874 of the Internal Revenue Code.

Section 7874 requires a corporation to pay tax on its "inversion gain" for 10 years after an inversion transaction, regardless of other tax attributes for the year, where:

> (i) a foreign corporation acquires, directly or indirectly, substantially all of the properties held, directly or indirectly, by a domestic corporation;
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> (ii) after the acquisition at least 60 percent (but less than 80 percent) of the stock of the foreign corporation is held by former shareholders of the domestic corporation by reason of their formerly holding stock in the domestic corporation; and
>
> (iii) after the acquisition the expanded affiliate group that includes the foreign corporation does not have "substantial business activities" in the country where the foreign corporation is organized.

Where shares held by former shareholders constitute at least 80 percent, the foreign acquiring corporation is treated as a domestic corporation, which would cause the purported inversion to fail to accomplish the desired tax objectives. Similar rules apply to foreign acquisitions of the trade or business of a partnership.

In Notice 2014-52, the IRS announced that Treasury will issue regulations to curtail certain strategies that have been used to avoid triggering the inversion rules, effectively tightening up the definition of an inverted company. Treasury will issue new regulations:

> (i) Limiting inclusion of passive assets in valuing the acquiring foreign corporation relative to the domestic corporation;

(ii) Preventing the domestic corporation from reducing its relative value through pre-inversion distributions; and

(iii) Preventing domestic corporations from inverting a piece of their business through "spinversions."

For tax purposes, these definitional changes apply prospectively, to potential inversion transactions occurring on or after September 22, 2014. In other words, a company that previously was acquired by a non-U.S. company without triggering the inversion limitations will not be treated as inverted for tax purposes as a result of the new definitional rules. This was also the case when Section 7874 was first adopted, as it originally applied to transactions occurring after March 4, 2003.

Separate government contract statutes and regulations restrict the ability of inverted companies to obtain government contracts. For example, 6 U.S.C. § 395 prohibits the Department of Homeland Security from entering into contracts with inverted companies. Ongoing appropriations restrictions prohibit other federal agencies from doing business with inverted companies. The definition of an inverted company for this purpose, although parallel in most respects, is not linked to the tax definitions. Also, in contrast to the prospective effective date for Section 7874, the government contract limitations on inverted companies apply to companies who engaged in transactions before, on, or after November 25, 2002.

The Notice also announced that Treasury will issue regulations to prevent inverted companies from taking advantage of the tax benefits of inversion through certain transactions. Treasury will issue new regulations:

(i) Under Section 956(e) to prevent an inverted company's use of "hopscotch loans" to access untaxed earnings of controlled foreign corporations without triggering section 956. The new regulations will treat such loans as investments in U.S. property that trigger current tax under subpart F.

(ii) Under Section 7701(l) to prevent the "decontrolling" of CFCs, and consequent freeing-up of untaxed CFC earnings, by migrating ownership of the CFC from the former U.S. parent to the new foreign parent. The new regulations will deem the CFC shares to be shares held by the old U.S. parent, preserving the status of the CFC as such.

(iii) Under Section 304 to prevent the foreign parent from selling an interest in the U.S. parent to a CFC that might otherwise permit accessing a CFC's earnings and profits without an intervening subpart F inclusion. (These new regulations will apply equally to inverted or non-inverted companies.)

The limits on tax benefits set forth in (i) and (ii) above will apply on or after September 22, 2014, to companies treated as inverted under the applicable rules at the time of the inversion but only if the inversion is completed on or after September 22, 2014. The limits on tax benefits set forth in (iii) above apply to sales of stock completed on or after September 22, 2014.

Notice 2014-52 also announces Treasury's intention to issue new regulations modifying the earnings stripping rules of Section 163(j) and requesting comments on the possible approaches. Unlike the other guidance, no details were given on what these new rules under Section 163(j) would be. Despite the lack of specificity, the Notice announces that to the extent revisions in the earning stripping rules apply only to inverted companies, they will apply to companies that completed inversion transactions on or after September 22, 2014.

The initial reaction to Section 7874 was a dramatic drop off in inversion transactions. Inversion transactions began to increase as practitioners developed techniques to deal with Section 7874, and as the gap between the U.S. corporate income tax rate and the rates in other countries widened. While the press reports indicate that certain companies intend to go forward with pending inversion transactions after Notice 2014-52, the recent attention has already stopped some companies from pursuing inversions. Notice 2014-52 is likely to reduce the number of inversions further. It is also likely that taxpayers will challenge at least some of the new rules in the Notice, or regulations adopted as announced in the Notice, as being outside the scope of Treasury's regulatory authority or improperly retroactive.

The IRS Notice does not purport to address restrictions on inverted companies obtaining government contracts. We will report on further developments in this area as they occur.

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