COVINGTON
COVINGTON & BURLING LLP

# E-ALERT | Tax and Public Policy & Government Affairs

October 3, 2014

## TREASURY PUBLISHES NOTICE ADDRESSING INVERSION TRANSACTIONS

On Monday, September 22nd, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) published Notice 2014-52 (the "Notice") announcing their intention to issue regulations that would address corporate inversion transactions. If issued in the form described in the Notice, the regulations would prevent certain narrow categories of inversions, including so-called "spinversions" and transactions involving a foreign company with predominantly passive assets. In most circumstances, however, the rules described in the Notice will only reduce, not eliminate, the tax benefits from an inversion. The precise impact of the rules on a particular proposed transaction will depend on the specific circumstances of the companies involved. The Notice states that its rules will apply retroactively to transactions that were completed on or after September 22, 2014, the date of the publication of the Notice.

## BACKGROUND

In a corporate inversion, the ownership of a U.S. corporate group is restructured in a way that causes the U.S. group to become owned by a non-U.S. parent company. Inversions have a long history, beginning in the 1980s, and previously inspiring anti-inversion regulations in 1995 and legislation in 2004. Under the 2004 legislation, if the former shareholders of the U.S. company own 80 percent or more of the equity of the new foreign parent, the inversion is effectively disregarded, with the new parent being treated as a U.S. corporation for all U.S. income tax purposes. If the former shareholders of the U.S. group own 60 percent or more of the combined group (but less than 80 percent), the non-U.S. status of the new foreign parent is respected, but certain adverse tax rules apply. Although earlier inversions generally involved an internal restructuring of a single U.S. company that redomiciled its parent corporation outside the United States, the recent wave of inversions typically involve mergers of two companies, each with significant business operations, but which nonetheless fall between the 60 percent and 80 percent tests because significant ownership of the combined group is acquired by shareholders of the non-U.S. target company.

Although such inversions involve a significant business combination, they may also provide a number of tax advantages. The principal U.S. income tax benefits from these transactions include: (1) reducing the U.S. taxation of the group's U.S. operations through the use of arrangements that result in the payment of interest (or other deductible expenses) to a foreign affiliate; (2) providing access to the U.S. group's "deferred" foreign earnings; and (3) eliminating the residual U.S. taxation of the group's future earnings from foreign operations.

### What the Notice seeks to do ...

**Nullify certain inversion transactions.** The regulations promised by the Notice are intended to nullify attempted inversion transactions in three specific situations:

- "Spinversion" transactions in which a U.S. company drops a business into a new foreign holding company that it then spins off to its shareholders;

- Transactions in which former shareholders of the U.S. group nominally acquire less than 80 percent of the new foreign parent stock, but where most of the foreign parent group's assets were passive; and
- Transactions in which former shareholders of the U.S. group nominally acquire less than 80 percent of the new foreign parent stock, but the U.S. parent makes extraordinary distributions (defined broadly to include not just dividends from the U.S. company, but also redemptions, spin-offs, etc.) that reduce its value prior to the merger.

**Limit access to deferred foreign earnings.** In all other cases, the regulations promised by the Notice will seek to limit the merged group's ability to access on a tax-free basis the "deferred" earnings of the U.S. group's foreign subsidiaries. The promised rules will:

- Require immediate U.S. taxation to the extent that the foreign earnings are loaned to or used to acquire equity in the new foreign parent or another foreign affiliate;
- Prevent the U.S. group from "de-controlling" its foreign subsidiaries; and
- Limit the U.S. group's ability to use certain related party stock sales to shift deferred foreign earnings out from under the U.S. group.

## And what the Notice does not do ...

The Notice does not alter the general definition of a pure inversion; the statutory 80 percent ownership threshold remains the standard for nullifying an inversion except in the three narrow circumstances identified in the Notice. Further, the Notice does not address the use of interest deductions to reduce the U.S. tax burden on the company's U.S. operations, although it does state that Treasury and the IRS "expect to" issue additional guidance addressing inversion, including possibly the U.S. interest deduction, and that this guidance would apply to companies that inverted on or after September 22, 2014.

## What does the Notice mean for ...

**... pending deals and others considering an inversion transaction.** Treasury specifically acknowledged that the Notice likely will not stop many of the announced transactions or transactions under consideration because these transactions involve real business combinations driven by non-tax consideration in addition to the tax benefits, and the tax benefits under the Notice have only been reduced and not eliminated.

**... the inversion issue more generally.** Because the Notice will not stop pending and future transactions, it will shift the focus of the policy debate back to Congress and a possible legislative response to deal with inversions directly, or as part of tax reform.

## What can Covington do for you?

Covington & Burling LLP has a team of professionals that can address all aspects of the inversion issue. Our tax lawyers have senior-level experience at the Treasury and the IRS, led by Michael Caballero, who served as International Tax Counsel at the Treasury during the first term of President Obama's Administration and was the staff attorney at Treasury responsible for the inversion issue when section 7874 was enacted.

We also have deep expertise to assist clients in both evaluating and navigating the policy debate on inversions within the Administration and on Capitol Hill. Our policy team is led by former Senator Jon Kyl, a former member of the Finance Committee who brings unique insights to how the debate is likely to shape up on Capitol Hill. He also has strong ties to senior Administration officials. Dan Bryant, the head of the firm's Public Policy and Government Affairs practice, also brings his experience as the former head of global government affairs for PepsiCo to helping an organization assess and respond to the political concerns surrounding an issue that necessarily requires the attention of senior company management.

---

If you have any questions concerning the material discussed in this client alert, please contact the following members of our tax practice group:


| | | |
|---|---|---|
| **Dan Bryant** | +1.202.662.5620 | dbryant@cov.com |
| **Michael J. Caballero** | +1.202.662.5610 | mcaballero@cov.com |
| **Senator Jon Kyl** | +1.202.662.5660 | jkyl@cov.com |