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IRS Issues Tough New Anti-Inversion Regulations

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The U.S. Treasury Department and the Internal Revenue Service (IRS) recently took a major step forward in their fight against inversion transactions by releasing an extensive package of new temporary regulations under section 7874 of the Internal Revenue Code. The new rules will affect pending deals, including ones already announced, and limit how new ones may be structured. The new rules generally incorporate previous guidance from Notice 2014-52 (2014 Notice) and Notice 2015-79 (2015 Notice) and add a new restriction on multiple inversions over a short time period.

The new rules take a considerably more aggressive approach to limiting inversions than previous guidance, presumably due to pressure from Congress and the Obama administration to stop U.S. businesses from relocating offshore in an effort to pay less U.S. tax. There is some question, however, whether the new provisions are outside the Treasury Department's authority.

The new provisions are expected to be effective when published in the *Federal Register*, which is expected to occur on April 8, 2016.

Background on Inversions

Section 7874 generally applies to an acquisition of a domestic entity by a foreign corporation when, after the acquisition, the former owners of the domestic entity own a threshold amount of the stock of the foreign acquiring corporation, and the expanded affiliated group (EAG) that includes the foreign corporation does not have "substantial business activities" in the foreign country in which the foreign corporation is organized.

If the former owners of the domestic entity own between 60% and 80% of the stock of the foreign corporation after the acquisition, the expatriated entity must pay tax on its "inversion gain" for 10 years after the inversion. Inversion gain is generally any income from the transfer or licensing of property either in connection with the inversion or, if afterward, to a foreign related person. Inversion gain cannot be offset by tax attributes such as net operating losses (NOLs). If the former owners of the domestic entity own at least 80% of the stock of the foreign corporation after the acquisition, the foreign corporation is treated as a domestic corporation for all U.S. federal tax purposes after the acquisition.

For the purpose of calculating the 60% and 80% thresholds, certain stock of the foreign acquiring corporation is disregarded. Section 7874 excludes stock issued in an IPO from this calculation, but the IRS has been adding categories of stock that must be excluded, in previous guidance and now in the new regulations.

Some provisions of the new rules applicable to inversions are as follows:

Multi-Step Acquisition Rule. The new regulations expand situations in which multiple steps must be considered together in measuring the ownership thresholds under section 7874. The new rules generally exclude stock of a foreign corporation from the ownership fraction under section 7874 if it was issued in connection with another domestic entity acquisition within the past 36 months.

Non-Ordinary Course Distributions Rule. Non-ordinary course distributions (NOCDs) made within 36 months before an inversion transaction will be added back in the calculation of the domestic target shareholders' percentage ownership in the foreign acquiring corporation. The new regulations include a complex set of rules to determine when a distribution made before an inversion transaction is a NOCD.

Third-Country Rule. Similarly, the new regulations disregard stock of a foreign acquiring corporation issued in exchange for a foreign entity acquired in connection with the acquisition of a domestic entity where the acquired foreign corporation is a resident of a different foreign jurisdiction than the foreign acquiring corporation (*i.e.*, in a "third country"). This rule now applies when (i) the foreign acquiring corporation acquires substantially all of the assets of another foreign corporation in connection with the acquisition of a domestic entity; (ii) at least 60% of the stock of the foreign acquiring corporation is held by former shareholders of the acquired foreign corporation; (iii) the tax residence of the foreign acquiring corporation is not the same as that of the foreign acquired corporation; and (iv) the ownership fraction determined without regard to the third-country rule is between 60% and 80%.

Subject-to-Tax Rule. The 2015 Notice included a provision under which the substantial business activities test is not met if the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country. The new regulations incorporate this test without any changes.

Inversion Gain Rule. Under section 7874, if an inversion transaction results in an ownership fraction of between 60% and 80%, then the expatriated entity must pay tax on its inversion gain for 10 years after the inversion. The new regulations expand the scope of inversion gain.

CFC Recharacterization Rule. The 2014 Notice described the Treasury Department's concern that certain transactions involving a domestic entity's controlled foreign corporation (CFC) after a 60% inversion (known as an "expatriated foreign subsidiary") could allow the group to escape tax under subpart F that would have otherwise resulted from the CFC. The new rules discourage such transactions by recharacterizing transfers of stock and property that cause dilution of the domestic entity's ownership of the expatriated foreign subsidiary.

Accelerated Gain. The new regulations trigger gain in certain transactions where nonrecognition provisions applied but where the transactions would permit gains to escape tax in the future.

The 2014 Notice and the 2015 Notice included provisions intended to prevent dilution of deferred offshore earnings. The temporary regulations incorporate that limitation.

The new regulations include most of the other rules described in the 2014 Notice and the 2015 Notice, but with some exceptions and limitations.

Conclusion

Before these regulations were issued, some thought was given to challenging the approach of the 2014 Notice and the 2015 Notice. Incorporating these rules in regulations will make any potential challenge harder to sustain.

However, a court might reasonably determine that the IRS has acted beyond its authority in issuing the new regulations. In particular, the provision on multi-step acquisitions could be challenged on the basis of its retroactive application, effectively punishing taxpayers for having engaged in inversion transactions within 36 months before the regulations were issued.

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