SHEARMAN & STERLING LLP

CLIENT PUBLICATION

TAX | November 23, 2015

Treasury and IRS Issue Additional Anti-Inversion Notice

The Treasury Department and the IRS released Notice 2015-79 (the "2015 Notice") on November 19th to further limit expatriation transactions and to supplement the anti-inversion guidance issued by them on September 22, 2014 (the "2014 Notice").

The 2015 Notice states that Treasury and the IRS will issue Treasury regulations to expand the scope of Section 7874 to apply to certain transactions and to address certain post-expatriation transactions so as to limit tax benefits of expatriations. The Treasury regulations announced in the 2015 Notice generally will apply to transactions completed on or after November 19, 2015 (*i.e.*, no grandfathering of previously announced transactions) but, in the case of Treasury regulations limiting tax benefits of expatriations, only if the expatriation transaction was completed on or after September 22, 2014 (*i.e.*, the date of the 2014 Notice).

Generally, a corporate inversion subject to Section 7874 is a transaction where a foreign corporation acquires a US corporation (or substantially all of its assets), the shareholders of the US corporation receive 60% or more of the stock of the foreign corporation and the foreign corporation does not have 25% or more of its worldwide operations following the acquisition in its country of organization. Under Section 7874(a)(1), such an inverted US corporation cannot use pre-acquisition losses to offset gain recognized during an "applicable period" of 10 years following the inversion. Under Section 7874(b), if the shareholders of the US corporation receive 80% or more of the stock of the foreign corporation, the foreign corporation will be taxable as a US corporation.

New Third Country Rule

Section 7874 generally applies based on whether shareholders of the US corporation receive 60% or more of the stock of the foreign parent company. Section 7874 does not contain any rules that would restrict the jurisdiction of the foreign parent company.

The 2015 Notice announces new Treasury regulations preventing a US corporation and a foreign corporation from having a foreign parent company that is a tax resident of a third jurisdiction. The rule generally applies if (i) the foreign parent company is a tax resident of a different jurisdiction than the acquired foreign corporation, (ii) the shareholders of the US corporation receive at least 60% of the stock of a foreign parent company and (iii) the gross value of the acquired foreign corporation exceeds 60% of the gross value of the foreign parent company (including the acquired foreign corporation but excluding the US corporation). If the rule applies, for purposes of Section 7874, the stock of the foreign parent company received by shareholders of the acquired foreign corporation will be disregarded in determining the percentage of foreign parent company stock received by the shareholders of the US corporation. Thus, this rule can apply where (a) a US corporation and a foreign corporation combine under a new foreign parent company, or (b) an existing foreign parent company acquires both a larger foreign corporation and a larger US corporation. In addition, if a foreign parent company changes its tax residence prior to but in connection with its acquisition of a US corporation, the rule will apply to disregard the stock of the foreign parent company held by its existing shareholders.

In announcing this rule, Treasury and the IRS appear to have extended their aggressive view of their authority to issue Treasury regulations under Section 7874.

Limitation on Substantial Business Activities Exception

Section 7874 does not apply to an expatriation transaction if at least 25% of the foreign parent corporation's worldwide operations (including the acquired US corporate group) are located in its country of organization. This 25% test generally must be met with respect to the employees, sales and assets of the foreign parent corporate group.

Under US tax rules, a corporation generally is treated as tax resident of the country in which it is created or organized. Tax rules of foreign countries may have different standards for determining tax residence, such as where the corporation is managed and controlled. Thus, a foreign parent company may not be a tax resident of the country of its organization.

The 2015 Notice announces new Treasury regulations that will provide that the foreign parent company must also be a tax resident in its country of organization to satisfy the 25% substantial business activities exception. This change may have limited impact because the 25% substantial business activities exception is a significant threshold for multinational corporations to meet, and few prior expatriation transactions have qualified for this exception.

Anti-Stuffing Rules

If shareholders of the US corporation receive 80% or more of the stock of the foreign parent company, Section 7874 applies to treat the foreign parent company as a US corporation for US tax purposes.

Current Treasury regulations disregard stock of the foreign parent company that is received by other shareholders in exchange for certain "stuffing" assets. For example, if in connection with the acquisition of a US corporation, an existing or new shareholder of the foreign parent company acquires additional stock in exchange for cash, this additional stock will be disregarded. Stuffing assets generally include three specified classes of assets consisting of cash (or cash equivalents), marketable securities and certain obligations (*e.g.*, obligations owed by the foreign parent company), as well as property transferred in connection with the acquisition of the US corporation with a principal purpose to avoid the purposes of Section 7874.

Treasury and the IRS expressed concern that taxpayers were interpreting the principal purpose asset class of the anti-stuffing rule as only applying to indirect transfers of the specified asset classes. Treasury and the IRS disagree with this interpretation, and the 2015 Notice describes clarifying changes to the anti-stuffing rules to provide that the principal purpose asset class can apply to any type of assets, even active business assets.

Accordingly, transfers of business assets to the foreign parent company in exchange for foreign parent company stock can be disregarded if it is determined that the foreign parent company acquired the business assets with a principal purpose of avoiding Section 7874. Factors in determining whether a transfer has such a principal purpose should take into account the relevance of the assets to the existing business operations of the foreign parent company.

Further Limits on Post-Expatriation Restructuring

Significantly, as with the 2014 Notice, the 2015 Notice did not announce any new "earnings stripping" Treasury regulations that would further limit deductions for interest paid by the US corporation to the foreign parent company (or non-CFC affiliates).

Expands Inversion Gain

Following an expatriation, US corporations consider restructuring transactions in which property, including stock of CFCs or intangibles, is transferred to its foreign parent company (or non-CFC affiliates). In addition, US corporations may license property to their foreign parent company (or non-CFC affiliates). Under Section 7874, US corporations generally cannot use pre-expatriation net operating losses or other tax attributes to offset gain or income recognized as a result of such restructuring or license transactions for the 10-year period following the expatriation (inversion gain).

Under these current rules, inversion gain does not include "subpart F" income of such US corporations resulting from transfers or licenses of property by a CFC. For example, if a CFC of a US corporation transferred the stock of another CFC to the foreign parent company, any income inclusion could be offset with available net operating losses. In addition, the transferred CFC would no longer be treated as a CFC and generally could loan or distribute earnings without such earnings being subject to US tax.

The 2015 Notice announces new Treasury regulations that generally will treat subpart F income resulting from restructuring or license transactions during the 10-year period as inversion gain and, thus, cannot be offset with pre-existing tax attributes of expatriated US corporations.

Built-in Gain in CFC Stock

Immediately following an expatriation, the foreign subsidiaries of the acquired US corporation remain CFCs. As CFCs, these foreign subsidiaries remain subject to the subpart F rules and Section 956. US corporations contemplating expatriation transactions typically integrate CFCs with non-CFC foreign subsidiaries of the new foreign parent and do so in a manner such that the resulting entity is not a CFC. Earnings of the former CFCs could be loaned or distributed to the new foreign parent without the earnings being subject to US tax.

The 2014 Notice described Treasury regulations to be issued providing that the US corporation must recognize built-in gain in the stock of any CFC that loses its CFC status in a restructuring transaction during the 10-year period following the expatriation. The amount of built-in gain, however, was limited to the earnings of the CFC that were not previously subject to US tax.

The 2015 Notice expands the announced Treasury regulations described in the 2014 Notice by requiring all built-in gain in the CFC stock to be recognized regardless of the amount of untaxed earnings of the CFC. As a result, CFC restructuring transactions could be more expensive to the extent that the CFC had appreciated property that had not yet generated significant untaxed earnings.

Exception for Insurance Companies

The 2014 Notice described Treasury regulations to be issued that expanded the scope of transactions subject to Section 7874. Under one rule, if more than 50% of the assets of the foreign acquiring corporation group are passive

assets, such as cash or marketable securities, then a proportionate amount of the stock of the foreign acquiring corporation will not be treated outstanding for purposes of the Section 7874 stock ownership tests. An exception for active banking assets was based on both the subpart F and PFIC rules while an exception for active insurance assets was only based on the subpart F rules. As a result, many insurance companies were concerned that combination transactions could be subject to Section 7874. The 2015 Notice adopts a similar exception for active insurance assets under the PFIC Rules.

Effective Dates for the New Rules

The 2015 Notice provides that the Treasury regulations described therein and discussed above under "New Third Country Rule," "Limitation on Substantial Business Activities Exception" and "Anti-Stuffing Rules" apply to transactions completed on or after November 19, 2015. No exceptions are provided for expatriation transactions that have executed transaction documents.

In addition, the 2015 Notice provides that the Treasury regulations described therein and discussed above under "Further Limits on Post-Expatriation Restructuring" will apply to transactions completed on or after November 19, 2015, but only if the expatriation transaction was completed on or after September 22, 2014. This effective date is consistent with the 2014 Notice, which provided that additional guidance would be applied prospectively but guidance that only applies to restructuring and other transactions of expatriated groups would apply to those groups that completed expatriations on or after September 22, 2014.

Additional Guidance

As with the 2014 Notice, the 2015 Notice also states that the Treasury Department and the IRS expect to issue additional guidance to further limit expatriation transactions that are contrary to the purposes of Section 7874 and the benefits of post-expatriation tax avoidance transactions. In addition, as with the 2014 Notice, the 2015 Notice specifically mentions that the Treasury Department and the IRS are considering guidance to address earnings stripping transactions. Unlike the 2014 Notice, however, the 2015 Notice does not provide any statements regarding the effective date of any future guidance.

CONTACTS

Laurence M. Bambino
New York
+1.212.848.4213
lbambino@shearman.com

Laurence E. Crouch
Menlo Park
+1.650.838.3718
lcrouch@shearman.com

D. Kevin Dolan
Washington, DC
+1.202.508.8016
kevin.dolan@shearman.com

Ethan D. Harris
Washington, DC
+1.202.508.8163
ethan.harris@shearman.com

Jeffrey A. Quinn
Washington, DC
+1.202.508.8000
jeffrey.quinn@shearman.com

Michael B. Shulman
Washington, DC
+1.202.508.8075
mshulman@shearman.com

Ryan Bray
Menlo Park
+1.650.838.3726
ryan.bray@shearman.com

Eric Grosshandler
New York
+1.212.848.7633
eric.grosshandler@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069