Inversions: The Next Round

On Thursday, November 19, 2015, the Treasury and the IRS issued Notice 2015-79 (the "Notice"), which builds on previous attempts to make inversions harder to accomplish and to reduce the economic benefit of inverting. The guidance described in the Notice will generally apply to transactions occurring on or after November 19, 2015.

Current Context for Inversions

A corporate inversion involves the conversion of a U.S. parent company of a multinational corporate group into a non-U.S. parent company. In an inversion transaction, a U.S. company and a non-U.S. merger partner typically transfer their operations to a new non-U.S. parent, which is jointly owned by the combining companies' shareholders. The new non-U.S. parent is usually domiciled in a jurisdiction that offers status as an international business center and a favorable tax regime. The new structure allows the multinational corporate group to minimize its exposure to U.S. corporate taxes.

Under the U.S. anti-inversion rules, a corporate inversion would generally be respected if either of two tests is satisfied:

- 80% Test: The transaction results in less than 80% (by vote and value) of the new non-U.S. parent being held by the former shareholders of the U.S. company; or
- Business Activities Test: After the transaction, the new non-U.S. multinational corporate group conducts substantial business activities in the home country of the new non-U.S. parent.

If neither of these requirements is met, then the transaction would not be respected for U.S. tax purposes. The new non-U.S. parent would be treated for U.S. tax purposes as a U.S. corporation—that is, it would be subject to U.S. corporate income tax on its worldwide income, including dividends from non-U.S. subsidiaries and gain on the sale of non-U.S. subsidiaries.

In response to significant political pressure, the Treasury and the IRS acted a year ago to tighten these rules. Although that briefly slowed activity, by mid-2015 inversions were again a regular feature of the international M&A market, with some of the biggest transactions to date being negotiated in the run-up to (and quite possibly prompting) the Treasury's and the IRS's release of the Notice. This latest guidance represents a renewed, but limited, effort by the government to rein in inversions. It arrives pending the 2016 presidential election and possibly, thereafter, congressional action to strengthen the anti-inversion statute – or perhaps to reform the U.S.'s international tax system (and tax rates) in order to remove some of the root causes for corporate inversion deals.

What Does the Notice Do?

The Notice makes some types of inversions harder to complete, and limits the advantages of post-inversion restructuring.

Restrictions on the on the ability to complete inversions.

- The 80% Test – residency rules: The Notice makes it much harder for an inversion to satisfy the 80% Test, where the new parent company is tax-resident in a different jurisdiction than the non-U.S. merger partner (e.g., a U.S. company and a Dutch company completing an inversion in which the new parent is tax-resident in the United Kingdom, rather than in the

Netherlands). The Notice provides that in such a transaction, the shares of the new non-U.S. parent that are held by former shareholders of the non-U.S. merger partner generally must be disregarded for purposes of the 80% Test. This greatly increases the likelihood that 80% or more of the stock of the new non-U.S. parent will be treated as held by former shareholders of the inverted U.S. company.

- The 80% Test – "anti-stuffing" rule: Prior guidance indicated that if the new non-U.S. parent issues shares in exchange for property (e.g., cash) with a principal purpose of avoiding the anti-inversion rules, those shares must be disregarded when applying the 80% Test to the new non-U.S. parent's acquisition of the inverted U.S. company. The effect of this "anti-stuffing" rule (as with the limit described in the preceding bullet point) is to increase the likelihood that the former shareholders of the U.S. company will be treated as owning 80% or more of the new non-U.S. parent. The Notice clarifies that the anti-stuffing rule applies not only when the property used to "stuff" the new non-U.S. parent is cash or passive assets, but also when active business assets are used.
- The Business Activities Test: This test cannot be satisfied under the Notice, unless the new non-U.S. parent is tax-resident in a country in which the post-transaction corporate group conducts substantial business activities. Previously, the new parent had to be formed under the laws of a country where the group conducted substantial business activities, but it did not have to be tax-resident there.

Limiting the benefit of an inversion.

- Moving non-U.S. businesses "out from under" the inverted U.S. company. Under the Notice, if the inverted U.S. company has a non-U.S. subsidiary (a "controlled foreign corporation" or "CFC") that sells or licenses assets to the new non-U.S. parent (or to any non-U.S. affiliates of such parent) within 10 years after the inversion deal, then the inverted U.S. company will be subject to U.S. tax on any income or gain from that sale or license that is distributed or deemed under the CFC regime to be distributed to the inverted U.S. company. The inverted U.S. company cannot use any of its losses or other tax assets to shelter the income or gain from tax.
- Reorganizations of the inverted U.S. company's CFCs. The Notice requires that the inverted U.S. company recognize gain on transfers of stock of its CFCs within 10 years after the inversion, even if the transfer of such stock would normally qualify as a tax-free reorganization for U.S. tax purposes. The U.S. company cannot use losses or tax attributes to offset this gain.

The Notice also makes a number of narrower changes, including changes to correct flaws in prior guidance.

What Now?

- The Notice fails to prevent merger partners from taking advantage of most of the key benefits typically created by inversions, most significantly the ability to extract profits from the inverted U.S. company, and to reinvest those profits outside the United States with no further U.S. corporate tax, and more generally to permit the combined group to derive synergies that remain outside the U.S. tax net.
- The Notice surprisingly contains no guidance preventing an inverted U.S. company from stripping earnings out of the U.S. tax net, by means of deductible interest, royalty or other payments by the U.S. company to the new non-U.S. parent and its non-U.S. affiliates. The Treasury and the IRS have been promising such guidance for well over a year, and repeated that promise in the Notice.
- The Notice largely prevents the removal of historic non-U.S. assets from the inverted U.S. company on a tax-free basis. However, once these assets have been removed from the U.S. company in a taxable transaction, subsequent earnings and gain associated with these assets will be free from U.S. tax.
- In the absence of action by Congress (which is not expected before the presidential election), the Treasury and the IRS may not be able to do much more to stem the tide of major inversion deals.

Tax contacts

Richard Catalano
Partner
T: +1 212 878 8421
E: richard.catalano
@cliffordchance.com

Anthony Fay
Foreign Legal Consultant
T: +852 2826 2407
E: anthony.fay
@cliffordchance.com

David Harkness
Partner
T: +44 20 7006 8949
E: david.harkness
@cliffordchance.com

Nick Mace
Partner
T: +44 20 7006 4679
E: nicholas.mace
@cliffordchance.com

David Moldenhauer
Partner
T: +1 212 878 8384
E: david.moldenhauer
@cliffordchance.com

Philip Wagman
Partner
T: +1 212 878 3133
E: philip.wagman
@cliffordchance.com

M&A contacts

Gary Boss
Partner
T: +1 212 878 8063
E: gary.boss
@cliffordchance.com

David Brinton
Partner
T: +1 212 878 8276
E: david.brinton
@cliffordchance.com

John Graham
Partner
T: +1 212 878 4955
E: john.graham
@cliffordchance.com

John Healy
Partner
T: +1 212 878 8281
E: john.healy
@cliffordchance.com

Sarah Jones
Partner
T: +1 212 878 3321
E: sarah.jones
@cliffordchance.com

Guy Norman
Partner
T: +44 20 7006 1950
E: guy.norman
@cliffordchance.com

Mark Poulton
Partner
T: +44 20 7006 1434
E: mark.poulton
@cliffordchance.com

Patrick Sarch
Partner
T: +44 20 7006 1322
E: patrick.sarch
@cliffordchance.com

Benjamin Sibbett
Partner
T: +1 212 878 8491
E: benjamin.sibbett
@cliffordchance.com

Andrew Whan
Partner
T: +852 2825 8903
E: andrew.whan
@cliffordchance.com

Nicholas Williams
Partner
T: +1 212 878 8010
E: nicholas.williams
@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

Clifford Chance US LLP

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Linda Widyati & Partners in association with Clifford Chance.