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Inversions: Tough New Rules

On Monday, April 4, 2016, the Treasury and the IRS issued temporary and proposed regulations which make it harder to successfully complete an inversion transaction, and to reduce an inverted US company's taxes through the use of intercompany debt.

Context for Treasury's New Actions

Perhaps stung by the widespread perception that its previous attempts to crack down on inversions were ineffectual, Treasury and the IRS have responded with unexpected vigor, making it much harder to execute these transactions - at least in the short term. The government's actions seem likely (and may have been intended) to keep public attention on inversions in this election year, and to help to ensure that the next administration continues to fight these transactions.

Until April 4, a non-US company was relatively free to participate in a series of inversion deals over time, with each one being bigger than the last. The new guidance makes it a lot harder to pursue such a "serial inversion" strategy. In addition, the government has moved aggressively to shut down a key tax benefit created by an inversion - the ability to lever up the inverted US company with debt owed to the new non-US parent (or other non-US affiliate). Until now, the inverted US company's tax-deductible interest expense on the debt would have substantially lowered its effective US tax rate. The new guidance would deny deductions for such interest, making many inversions a lot less attractive. In a surprise to many, the rules would hit not just inversions, but the use of intercompany debt in a wide range of other cross-border deals as well, many of which until now had settled US tax treatment.

It is not entirely clear whether Treasury and the IRS have legal authority to issue the latest rules, in the absence of Congressional action. However, at least to some extent, that may be beside the point. The rules are too far-reaching and too punitive for market participants to ignore, in the short term, forcing some companies to think hard about abandoning deals. In a year or so a new administration will have extra incentive to work with Congress promptly to amend the inversion laws, and perhaps to reform the US's international tax system more widely.

For added context, the timeline on page 4 shows key recent inversion deals and developments.

Practical Impact of the New Rules

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

Restrictions on the ability to complete inversions.

- *Serial inversions* – For an inversion to work, a non-US company normally must represent over 20% of the participants' combined equity value, with the US inverted company(ies) representing less than 80%. In a case where Non-US Co merges first with US Co A, and then at a later time with US Co B, the parties might try to apply the 80/20 test to the deal with US Co B by comparing its equity value, with the equity value of Non-US Co at such time (which will have been fattened up by Non-US Co's previous merger with US Co A). The new rules provide that, if these mergers occur within 3 years of each other, then the 80/20 test must be applied to the US Co B deal, by ignoring the portion of Non-US Co's equity value that is attributable to its prior merger with a US company.

- *Multi-step acquisitions* – If a non-US company completes a series of transactions pursuant to a single, overall plan for one or more US target companies to invert, then whether or not those transactions occur within 3 years of one another, the new rules will apply the 80/20 test (and other requirements that must be satisfied in order to invert successfully) in an unfavorable manner to these transactions.
- *Rules implementing the 2014 and 2015 guidance* – The regulations provide additional detail and clarifications to a range of rules issued by the government in its last two pronouncements on inversions.

In view of the new rules, when a non-US company considers merging with a US counterparty in the future, the non-US company generally will be well-advised to closely review its own prior history of mergers and acquisitions of US companies, in order to determine how the 80/20 test will apply to the new merger. The same holds true when a non-US company seeks to acquire another non-US company that has previously participated in an inversion.

The above rules are generally effective for inversions occurring on or after April 4, 2016.

Expansive new earnings stripping rules impact post-inversion structuring.

The new rules require debt issued between related parties, including debt issued by an inverted US company to its non-US parent (or affiliate), to be treated as equity for US tax purposes in many cases, resulting in a loss of interest deductions.

- *Bifurcation of "debt" into part debt, part equity* – Treasury and the IRS would now be allowed to treat a debt instrument as in part debt and in part equity for US tax purposes, if doing so would properly reflect the substance of the parties' transaction (e.g., if the issuer is expected to be able to pay off part, but not all, of the debt). Taxpayers would not be allowed the same freedom to choose to treat an instrument as part-debt, part-equity on their tax returns.
- *Documentation substantiating an arrangement as true debt* – Treasury and the IRS propose to treat as equity purported debt instruments which are not documented in a manner that would be typical for transactions between unrelated parties. Required documentation generally would include a written loan agreement or similar agreement, as well as evidence supporting an expectation that the borrower can repay the debt when due, and evidence that the parties' rights are being respected (e.g., payments are made on time). Documentation generally would need to be prepared within 30 days after the debt is put in place or 120 days following a payment or default under the debt. The documentation requirements generally apply only to related parties that satisfy an 80% common ownership (by vote or value) threshold and meet certain publicly traded stock requirements or asset ($100 million) or annual revenue ($50 million) thresholds.
- *Distributions of debt instruments between related parties* – The government would treat debt instruments as equity when the debt is issued by a company in the following circumstances. Until now, these techniques were commonly used to load up an inverted US company with debt owed to non-US affiliates:
  1. distribution of debt by a company to its related corporate shareholders;
  2. issuance of debt by a company as consideration for its acquisition of shares of an affiliate;
  3. issuance of debt as consideration in certain intra-group transactions in which one company merges or transfers its assets to another; and
  4. issuance of debt by a related party with a principal purpose of funding a distribution or acquisition described in the foregoing prongs (1) through (3). A "principal purpose" is automatically deemed to exist if a company borrows from a related party within 36 months before, or after, the company completes one of those transactions.

  The rules in the above prongs generally will not apply, unless or until the total principal amount of debt owed among parties in the related-party group that would otherwise be treated as equity under prongs (1) through (4) exceeds $50 million. Limited other exceptions also may apply.

While these rules are meant to destroy the benefits of inversions, they reach far beyond that to also hit (for example):

- a non-US company's cash purchase of a US target in a non-inversion deal, followed by a pushdown of debt to the US target;
- a US company's insertion of debt into its non-US subsidiaries, as part of its planning to repatriate profits of those subsidiaries back to the US;
- leveraged blockers used by some private equity funds and hedge funds in cross-border investments into the US; and
- a host of restructurings and demergers of corporate groups.

Treasury and the IRS have said that the rules described in the first two bullet points above (bifurcation, and documentation) are to apply to debt issued on or after the date the rules are issued in final form. The rules described in the third bullet point (distributions) are to apply to debt issued on or after April 4, 2016.

What Now?

- At least in the short term, the economics for many potential inversions have just become a lot less attractive, and some deals may be abandoned. Inversions also have become much harder to complete without problems under the 80/20 test.
- Inversions do still offer the benefit of allowing the US inverted company to expand its business internationally, without the need for US tax on profits earned overseas. This can be a big benefit under the current US tax system.
- The next President and Congress will have a lot of incentive to act, whether to ratify the approach Treasury and the IRS have just taken because they agree with it, or to reject the approach and, possibly, overhaul (rationalize) the US's international tax rules.
- If the new rules about related-party debt remain unchanged, they could have a big impact on a range of companies and transactions outside the context of inversions.
- More than ever before, it will be important for related parties to promptly and properly document even garden-variety intercompany receivables and payables, to avoid potentially drastic US tax consequences. Taxpayers also will need to plan carefully for debt borrowed by a related party that is highly levered, or whose ability to pay otherwise might be in doubt.
- Post-acquisition debt pushdowns, and other types of restructurings to lever up a related party – particularly a US subsidiary of a non-US parent or vice versa – will need to be carefully structured to manage the potential impact of the new rules.

Appendix - Timeline

May 2014 – President Obama calls inversions an "unpatriotic tax loophole".

June 2014 – Medtronic (US) and Covidien (Ireland) announce a $42.9 billion merger. The new company would be located in Ireland.

July 2014 – AbbVie (US) and Shire (Jersey/Ireland) announce a $54.8 billion merger, the largest pharmaceutical merger at the time. The new company would be located in Ireland.

August 2014 – Burger King (US) and Tim Hortons (Canada) announce an $11 billion merger in a deal that creates the third-largest fast-food company. The merged company would be located in Canada. The innovative transaction is structured to avoid triggering gain in US shareholders' stock in Burger King.

September 2014 – The IRS releases new guidance intended to further restrict inversion transactions, applicable to transactions that are completed after the date of the guidance. See, **2014 Clifford Chance Client Briefing**.

October 2014 – AbbVie and Shire call off merger in response to recent IRS guidance.

December 2014 – Burger King and Tim Hortons complete merger.

January 2015 – Medtronic and Covidien complete merger.

May 2015 – US Treasury Department announces proposed revisions to the United States' model income tax treaty. In a press release, the Treasury Department announces that one of the goals of the revisions is to deny tax benefits for payments made from inverted US companies.

May 2015 – A few days after the Treasury Department's announcement, Broadcom (US) and Avago (Singapore) announce a $37 billion merger. The new company would be located in Singapore.

November 2015 – The IRS releases additional guidance restricting inversions. See, **2015 Clifford Chance Briefing**.

November 2015 – One day after the release of IRS guidance, Medtronic announces that the guidance does not have a material financial impact on the company.

November 2015 – Four days after the release of IRS guidance, Pfizer (US) and Allergan (Ireland) announce a $160 billion merger, the third-largest M&A deal ever. The new company would be based in Ireland.

February 2016 – Completion of Broadcom/Avago merger.

April 2016 – US Treasury Department issues new temporary and proposed regulations regarding inversions and thin capitalization.

April 2016 – One day after the Treasury Department announces new regulations, Pfizer and Allergan are reported to have decided to terminate their planned merger.

July 2016 – Democratic and Republican conventions. The presidential candidates chosen at these conventions will likely have proposals relating to US corporate tax reform (including inversions).

November 8, 2016 – Presidential election.

2017 – US corporate tax reform?

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