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Federal Tax ADVISORY ■

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Inversions

Notice 2014-52

The hottest topic in federal corporate taxation in many years is the corporate inversion. The Treasury Department recently released Notice 2014-52, which attempts to slow down the mini-stampede of inversions by proposing seven regulations making it both more likely that an inversion will be subject to the 2004 statute that adopted Section 7874 and more difficult to move cash in controlled foreign corporations (CFCs) owned by the inverted U.S. parent (USP) into the new foreign holding company (FHC).

What Is an Inversion?

An inversion occurs when shareholders of a USP wind up owning stock of the FHC that owns the USP. This can occur in a number of ways, the simplest being that a subsidiary of the FHC merges with the USP in exchange for stock of the FHC.

If the shareholders of the USP receive less than half the stock of the FHC, then such a transaction can occur completely tax free, and there is no inversion for purposes of Section 7874. However, there also is no inversion for commercial purposes but instead there has been a takeover: the FHC has taken over the USP and the FHC's historic shareholders are in control of the business.

Such a takeover is not typically what the USP and its management are interested in. Instead, they want to be the acquirers. One problem with the USP being the acquirer is that usually it means that even a stock for stock swap by the USP shareholders will be taxable to the shareholders. However, most inverting companies have not seen this as an obstacle.

Therefore, a USP typically will plan a combination with a smaller FHC that will allow the USP shareholders to receive up to but less than 80 percent of the vote or value of the FHC or of a new foreign holding company resulting from the combination with the FHC. If they were to receive 80 percent, the FHC would be treated as domestic, the tax benefits of inversion would be lost and the FHC would be in a worse position than when it started.

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What the Notice Does

First, the notice adds several rules to make it harder for the USP to avoid the 80 percent threshold or the lower threshold of 60 percent ownership by the former USP shareholders, which if avoided can free the USP of some softer sanctions. Generally, however, the USP shareholders will receive closer to but less than 80 percent of the FHC stock. The tightened rules can make it somewhat hard to plan around the statute but should not stymie many inversions.

Second, the notice adds several rules intended to make it harder to access the earnings of CFCs. For example, assume a USP owns CFCs that have been operating abroad for many years and have accumulated $10 billion in earnings that are "permanently reinvested" offshore. Therefore, no U.S. income tax has been paid on these earnings (and no tax is expected to be paid for accounting purposes). This arrangement works well as long as the CFCs can continue to use the earnings for foreign growth. But a problem with the arrangement is that ultimately it is possible that some part of the foreign earnings will be taxed in the United States when paid to the USP for its own uses.

Assume that a USP inverts under an FHC. Now the FHC owns the USP, which still owns its CFCs, which still hold $10 billion. If some of the cash could be lent to the FHC, it could use the cash to grow the group's business abroad so as to produce future income that would never be taxed in the United States. That is the ultimate goal of inversions.

The notice attempts to cut off such a plan by treating such a loan as made first to the USP, which was then on-lend to the FHC. The deemed loan to the USP will be subject to tax as if it were a dividend paid to the USP.

The notice also addresses a scheme whereby an FHC might contribute some of its foreign subs to a CFC of a USP in exchange for stock of the CFC. This could have the effect of ending the status as a CFC and removing the $10 billion from potential U.S. taxation. The proposal attacks this by treating the contribution as made first to the USP, which then makes the same contribution to the CFC.

Effective Date

The proposals apply to companies that inverted on and after September 22, 2014. That means that when these regulations are finalized, which could be a year or more in the future, they will have been in effect for some time. Most of the rules continue to apply for 10 years after the inversion. Therefore, if the companies in our example can wait out 10 years, perhaps they can move the $10 billion to the FHC without U.S. tax, but by then the entire tax landscape may have changed.

The Future

It is generally thought that the proposals will slow down but not stop inversions. Certainly inversions will need to be real business combinations, and most have been in recent years. There may be some attacks on the regulations, questioning the authority of the Treasury to issue them. Also, the regulations may become irrelevant if Congress creates some entirely different way to deal with foreign earnings of U.S. corporations.

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