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Federal Tax ADVISORY ■

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The Inversion Sweet Spot

U.S. corporations may want to combine with a foreign corporation under a foreign charter. For U.S. tax purposes, this is called an inversion, meaning that the U.S. corporation is inverted under the ownership of a foreign holding company.

To make an inversion work, a U.S. corporation must find a foreign combination partner. A U.S. corporation may invert under the foreign corporation or both may become subsidiaries of a foreign holding company.

If the shareholders of the U.S. corporation get stock of the holding company as part of the deal, tax planning is key to finding the inversion sweet spot and avoiding the punitive Section 7874 anti-inversion rules.

If the U.S. corporation's shareholders get 80% or more of the foreign holding company stock, the foreign holding company will be taxed as a U.S. corporation, which defeats the tax purpose of the inversion.

If the U.S. corporation's shareholders get between 60% and 80% of the stock, the deal may not work because of the tax disadvantages, such as a potentially significant tax liability for the expatriated domestic corporation and certain related parties.

If the U.S. corporation's shareholders get between 50% and 60% of the stock, the only tax drawback is that the shareholders' stock exchange could be taxable under Section 367(a).

If the U.S. corporation's shareholders get less than 50% of the stock, the inversion may be tax-free all around. However, being the smaller of the combination partners could have negative management consequences.

Those are the base cases.

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Far more complexity arises if there is cross-ownership between the foreign acquirer and the domestic corporation, including merely shuffling around the ownership of corporations within an affiliated group. Indeed, those are the scenarios on which we most often advise. The "accidental" inversion is the most dangerous case.

An accidental inversion can occur when a U.S. parent corporation expatriates a U.S. subsidiary that has minority shareholders. If the minority shareholders retain more than a 20% interest in the new foreign corporation, the IRS could treat the transaction as an inversion under Section 7874 and the new entity as a domestic corporation.

You can avoid this by using the Treasury Regulations Section 1.7874-1(c) "internal group restructuring" exception that applies to a U.S. subsidiary that is, directly or indirectly, at least 80% owned by its U.S. parent before and after its expatriation.

An expatriation qualifies as an internal group restructuring if: (1) before the expatriation, 80% or more of the stock (by vote and value) in the U.S. subsidiary was held directly or indirectly by the corporation at the top of the overall corporate group after the expatriation; and (2) after the expatriation, 80% or more of the stock (by vote and value) of the foreign holding company is held directly or indirectly by the corporation at the top.

In an internal group restructuring, stock held by one or more members of the overall corporate group is included in the denominator, but not in the numerator, of the ownership fraction, so no inversion occurs under Section 7874 when a U.S. parent corporation expatriates its 80%-owned U.S. subsidiary and still retains, directly or indirectly, at least 80% of that subsidiary's stock.

There are other considerations. For example, if a corporation that directly owns stock in a U.S. subsidiary receives stock of a foreign holding company via repatriation and transfers the stock in a related transaction, the transferred stock won't benefit from the exception unless another exception applies.

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