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"Inversion": A Cross-Border Acquisition Structure

A structure currently being used by U.S. corporations to acquire a foreign corporation is colloquially referred to as an "inversion." The resulting structure is a new foreign parent that owns the U.S. corporation and the foreign target.

To illustrate, assume a U.S. publicly traded corporation intends to acquire a foreign corporation. Typically, a new foreign corporation is formed in a country with flexible corporate laws and beneficial tax rules (*e.g.*, the United Kingdom, Ireland or the Netherlands). The shareholders of the U.S. corporation and the shareholders of the foreign target effectively transfer their shares to the new foreign corporation in exchange for stock. The shareholders of the foreign target may also receive cash.

In addition to important nontax business reasons underlying the combination transaction, a foreign-parented structure is compelling for tax reasons. The United States has the highest corporate tax rate (approximately 40 percent) of any developed country. It is materially higher than the tax rates in most European countries (*e.g.*, the U.K. tax rate is 21 percent and falling). The United States also taxes dividends received from foreign subsidiaries, in contrast with most other developed countries, which exempt earnings outside the parent's jurisdiction. The U.S. tax system results in domestic-parented companies incurring significantly greater tax costs than their foreign-based competitors and also has resulted in trillions of dollars of cash becoming effectively "trapped" in foreign subsidiaries because repatriation to the United States would trigger a large incremental U.S. tax cost.

A key benefit of an inversion acquisition structure is that the foreign target remains completely outside the U.S. tax net (*e.g.*, it is held directly by the foreign parent). For example, if a foreign target has an effective tax rate of 25 percent, a foreign-parented structure avoids subjecting its earnings to a 40-percent U.S. tax rate. Such a structure also permits use of the cash of the foreign target without the U.S. repatriation tax (and the U.S. Subpart F rules would not apply to tax certain undistributed earnings of foreign subsidiaries). Furthermore, future acquisitions and business expansion can be achieved outside the onerous U.S. tax net. Absent these tax savings, which are available only in the context of an inversion, a U.S.-based corporation would be at a significant disadvantage to a foreign-based corporation in bidding for a foreign target.

Another important benefit of a foreign-parented structure is the ability to insert debt in the United States, providing an interest deduction that reduces earnings otherwise subject to a 40-percent tax rate. This might be implemented as part of the acquisition transaction, or at a later time. The additional interest expense places a former U.S.-based corporation on par with a foreign-based corporation.¹

A third benefit is the ability of a foreign parent to access cash of the foreign subsidiaries of the U.S. corporation. The foreign subsidiaries generally can loan funds to the foreign parent without U.S. taxation (whereas a similar loan to a U.S. parent generally would be taxable as a dividend under Subpart F).² The foreign parent can use the funds for dividends, stock buy-backs and acquisitions. As discussed below, however, a recent IRS Notice has removed this benefit under certain circumstances.



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To achieve a foreign-parented structure, the foreign target shareholders must receive more than 20 percent of the stock of the foreign parent by vote and value (*i.e.*, the foreign target's value is at least 25 percent of the value of the domestic corporation).³ If the shareholders of the U.S. corporation receive 80 percent or more of the stock of the new foreign parent, the new foreign parent generally will be treated as a domestic corporation, *i.e.*, there would be no inversion.⁴ A recent notice issued by the IRS can make this test more difficult to satisfy in close cases by disregarding certain distributions of the domestic corporation that would otherwise reduce its value and not attributing value to certain nonoperating assets of the foreign target.⁵

Most agree that the U.S. international tax system is in desperate need of reform to bring it more in sync with the tax regimes of the rest of the developed countries.

There generally would be no corporate-level tax with an inversion acquisition structure. On the other hand, if the shareholders of the domestic corporation receive more than 50 percent of the stock in the new foreign parent, they generally are subject to tax on their gain (but many shareholders may be tax exempt).⁶

As mentioned above, a recent IRS Notice has significantly limited the ability of a foreign parent to access cash of the foreign subsidiaries of the U.S. corporation. Under Notice 2014-52, the amount of any investment by a controlled foreign corporation of the domestic corporation in

the stock or debt of the foreign parent (or its subsidiaries) will be treated as an investment in U.S. property subject to Code Sec. 956.⁷ As a result, the U.S. corporation generally will be taxable on the amount of any such loan or stock investment as a deemed dividend. This rule, however, does not apply to an acquisition inversion where the U.S. corporation's shareholders receive less than 60 percent of the stock of the foreign parent or acquisition inversions occurring prior to September 22, 2014, nor does it apply to loans or stock investments made by the foreign target or its subsidiaries.

Code Sec. 956 treats as a deemed dividend an investment by a CFC of its earnings in U.S. property, *e.g.*, a loan to a related domestic corporation. A loan to (or stock investment in) a foreign corporation is not within the definition of U.S. property and therefore is not subject to Code Sec. 956. The IRS's expansive treatment of a loan to (or stock investment in) a foreign parent as triggering a deemed dividend to the domestic parent when the investment is clearly not U.S. property and the domestic corporation does not receive the cash seems to be vulnerable to a successful challenge by taxpayers.

Most agree that the U.S. international tax system is in desperate need of reform to bring it more in sync with the tax regimes of the rest of the developed countries. The United States, as a world leader and one of the largest economies, should be at the forefront of developing a tax system that fosters economic growth and minimizes the impact of taxes on acquisitions and business decisions. It is unfortunate that while we are waiting for tax reform, our government continues to pursue rules that result in U.S. corporations paying materially higher taxes than their foreign-based competitors. Europe got it—most countries now have corporate tax rates in the low 20s and exempt foreign earnings—and European corporations will continue to acquire our U.S. corporations until we get it too.

ENDNOTES

¹ Code Sec. 163(j) generally limits to 50 percent of adjusted taxable income the amount of deductions for interest paid to related foreign persons and interest on loans guaranteed by related foreign persons.

² Code Secs. 951(a)(1)(B), 956.

³ Code Sec. 7874(a)(2).

⁴ Under Treasury regulations, if at least 25 percent of the group's employees (by headcount and compensation), income and assets are located in the country where the foreign parent is orga-

nized, the foreign parent will not be treated as a domestic corporation even if the shareholders of the U.S. corporation receive 80 percent or more of the stock of the new foreign parent. It would be rare for this test to be met. For example, this test could not be satisfied if the group conducted 90 percent of its business outside the United States, but less than 25 percent in any particular country. Reg. §1.7874-3T.

⁵ Notice 2014-52, 2014-42 IRB. 1 (September 23, 2014).

⁶ Reg. §1.367(a)-3(c)(3)(iii)(A). Also, for certain inversions, an excise tax can apply to certain stock based compensation (Code Sec. 4985), and limitations are imposed on the use of certain corporate tax attributes (Code Sec. 7874(a)(1)).

⁷ The notice also makes it more difficult to restructure the ownership of a foreign subsidiary of the U.S. corporation to no longer be a controlled foreign corporation.