DORSEY

New Corporate Inversion Regulations Provide Useful Exception for Certain Companies

June 12, 2012
Attorney Articles

On June 7, 2012, the Internal Revenue Service and Department of the Treasury issued new regulations that allow U.S. corporations to determine with greater certainty whether they may avoid application of the anti-inversion rules by qualifying for the substantial business activities exception.[1] The new regulations may have a significant impact on the ability of U.S. corporations to redomicile outside of the U.S. to jurisdictions in which they conduct the requisite amount of business activities (generally, through subsidiaries).[2] In fact, insurance giant Aon Corp. (ranked 235th on the Fortune 500) relied on the substantial business activities exception in its recent inversion with which it moved its corporate headquarters from Chicago to London.[3]

The new regulations may be particularly beneficial to non-U.S. corporations that previously formed U.S. holding companies for purposes of accessing capital in the U.S. but whose operations remain largely in one jurisdiction outside of the U.S. and who now prefer to redomicile their headquarters to their original jurisdictions. The regulations are less beneficial, however, to U.S.-based multinationals who sell on a worldwide basis and operate in multiple jurisdictions, and, therefore, are not able to satisfy the relatively high single-jurisdiction thresholds required for the new exception.

Background

In order to discourage U.S. corporations from “redomiciling” or “reincorporating” offshore (particularly into tax haven jurisdictions), Congress enacted Section 7874 of the Internal Revenue Code (the “anti-inversion rules”) to penalize corporations undertaking such inversions by either continuing to tax them as U.S. corporations or else eliminating their ability to utilize certain tax attributes. A common inversion involves the formation of a new offshore holding company which acquires all of the stock or assets of an existing U.S. company so that the U.S. company generally becomes a subsidiary of the offshore holding company and former shareholders of the U.S. company become shareholders of the new offshore holding company.

Under Section 7874, if a foreign corporation acquires a U.S. corporation[4] and (a) following such acquisition, the former shareholders of the U.S. corporation own 80% or more of the foreign corporation by reason of their ownership of the U.S. corporation;[5] (b) the foreign corporation directly or indirectly acquires substantially all of the assets of the U.S. corporation and (c) the foreign corporation does not have substantial business activities in its country of incorporation, generally the foreign corporation will continue to be treated as a U.S. corporation for U.S. tax purposes.

If the jurisdiction in which the foreign corporation is formed imposes tax on

Authors

John Chase

Related Services

Tax Litigation

Tax, Trusts and Estates

Related Offices

Palo Alto

corporations, the foreign corporation generally would be subject to double taxation – corporate tax in its country of incorporation as well as U.S. corporate tax. In addition, the foreign corporation could be required to withhold tax on dividends that it pays to its shareholders under both the withholding tax rules of its country of incorporation as well as the withholding tax rules of the U.S.

While the potential for double taxation generally discourages inversions, one plausible benefit of the application of the anti-inversion rules is that by treating the foreign corporation as a U.S. corporation, the exchange of U.S. company stock for offshore holding company stock may potentially be structured as a tax-free reorganization for U.S. tax purposes, thereby allowing U.S. shareholders to exchange their stock without immediately recognizing gain. In the absence of Section 7874, an exchange of U.S. company stock for offshore holding company stock would be subject to the anti-expatriation rules of Section 367(a) of the Internal Revenue Code, which generally requires U.S. shareholders to recognize gain on any appreciation in their U.S. company stock (that is, shareholders generally recognize gain on the difference between the fair market value of the offshore holding company stock and their tax basis in the U.S. company stock). Section 7874, however, effectively trumps Section 367(a), thereby allowing the recognition of gain to be deferred, provided that the share exchange is otherwise structured as a tax-free reorganization between two U.S. corporations.

Certain U.S. corporations (particularly “growth” companies that do not anticipate paying dividends) have considered affirmatively using Section 7874 to reincorporate into tax haven jurisdictions – while avoiding gain recognition to their U.S. shareholders – for purposes of going public on non-U.S. stock exchanges.

New Regulations

The June 2012 regulations replace the “facts and circumstances test” found in prior regulations[6] with a “bright-line” rule in order to provide “more certainty” and improved “administrability” for U.S. corporations seeking to satisfy the substantial business activities test and avoid application of the anti-inversion rules. The new regulations provide that a foreign corporation’s “expanded affiliated group”[7] will have substantial business activities in the relevant foreign country if at least:

- twenty-five percent of the group’s employees – by headcount and compensation;[8]
- twenty-five percent of the group’s assets – tangible personal property and real property;[9] and
- twenty-five percent of the group’s gross income – from unrelated customers[10]

are located or derived in the relevant foreign country.

Impact on Corporate Inversions

By providing greater certainty as to when the substantial business activities requirement is satisfied, the new regulations allow U.S. corporations to evaluate whether their current business operations outside of the U.S. may allow them to avoid application of the anti-inversion rules, and if not, whether their projected operations could satisfy the bright-line criteria in the future.

Specifically benefiting from the new regulations are non-U.S. corporations that previously formed or acquired U.S. holding companies for purposes of accessing capital in the U.S. but whose operations remained largely in one jurisdiction outside of the U.S. Such corporations may have reconsidered the usefulness and

practicality of a U.S. holding company structure and may prefer to redomicile their parent company back into their original jurisdiction. The bright-line rule will allow such corporations to determine whether they may avoid application of the anti-inversion rules. If the substantial business activities test is satisfied, however, the inversion would continue to be subject to the anti-expatriation rules of Section 367 (a), which, depending on the form of the inversion, generally may result in gain recognition to U.S. Shareholders upon the exchange of their U.S. corporation stock for new non-U.S. stock.[11] As a result, inversions that satisfy the substantial business activities test are particularly well suited for corporations in which U.S. shareholders have little or no appreciation in their stock.

The new regulations are less beneficial to multinational corporations who sell on a worldwide basis to multiple jurisdictions and do not derive twenty-five percent of their income from any one particular jurisdiction.

Questions Remain

Noticeably absent from the June 2012 regulations is any guidance regarding stock issued in a private placement in connection with an inversion, as promised by Notice 2009-78,[12] which indicated that future regulations would prohibit such stock from being counted for purposes of the 80% test under Section 7874.

Pursuant to Section 7874(c)(2)(B), any stock issued in a “public offering” related to the inversion is disregarded in determining whether the former shareholders of the U.S. corporation own 80% or more of the foreign corporation.[13] Congress originally excluded stock issued in a private placement (along with public offering stock) from the 80% test, but the private placement exclusion was struck from the final version of the legislation.

The Notice states that the Internal Revenue Service and Department of the Treasury have become aware of transactions that, in their view, were designed to inappropriately avoid the anti-inversion rules. One such transaction involves the transfer by shareholders of stock in a U.S. corporation to a new foreign corporation in exchange for 79% of the foreign corporation’s stock, and, in a related transaction, a transfer of cash by an unrelated third-party investor to the foreign corporation for the remaining 21% of the foreign corporation’s stock. The parties assert that the stock issued to the third-party investor was not “sold in a public offering” and thus not subject to Section 7874(c)(2)(B) and that the principal purpose of the third-party’s cash investment was not to avoid application of the anti-inversion rules (e.g., it was required to satisfy the corporation’s working capital needs). The Notice states that such transactions are inconsistent with the purposes of Section 7874 and that future regulations will disallow counting stock issued to the third-party investor (thereby causing the existing shareholders to fail the 80% test) for transactions completed on or after September 17, 2009.

The June 2012 regulations provide no guidance on the prohibition of private placement stock for purposes of the 80% test. The preamble to one of the regulations states that the Internal Revenue Service and Department of the Treasury are studying the issue and request comments from the public. A Treasury official has stated informally that additional regulations may be issued later this summer.

[1] T.D. 9592, 06/07/2012. The “substantial business activities” regulations were issued as temporary regulations. Concurrently, the “surrogate foreign corporation” regulations under Section 7874 also were issued as final regulations (T.D. 9591, 06/07/2012). Together, the two sets of regulations are referred to as the “June 2012 regulations.”

[2] While this eUpdate focuses on the substantial business activities test, the June 2012 regulations also include rules applicable to the treatment of options, downstream reorganizations, insolvent entities and partnerships in the context of inversion transactions.

[3] See Aon 2012 Proxy Statement – Special Shareholder Meeting. Aon relied on the prior version of the substantial business activities exception found in the 2009 regulations, and the inversion required as a closing condition an opinion of counsel concluding that Section 7874 should not apply.

[4] Section 7874 also applies to the acquisition of a U.S. partnership.

[5] Section 7874 also includes a 60% threshold. If former U.S. shareholders or partners receive at least 60% but less than 80% of a foreign corporation's stock, the U.S. entity is limited in its ability to use tax attributes (such as net operating losses and credits) to reduce its U.S. tax on income from certain transactions with related foreign persons for a ten-year period.

[6] Temporary regulations issued in 2006 stated that the determination of whether the foreign corporation has substantial business activities is based on all the "facts and circumstances." The 2006 regulations also provided a "safe harbor" which generally was satisfied if at least ten percent of the employees, assets and sales of the foreign corporation and its affiliated group were located in the relevant foreign country. Temporary regulations issued in 2009 retained the "facts and circumstances" test but removed the ten percent safe harbor. Removal of the safe harbor discouraged inversions for those who believed that the subjective nature of a "facts and circumstances" standard, in the absence of a safe harbor, resulted in an unacceptable level of audit risk.

[7] Generally, the foreign corporation and its affiliates with greater than fifty percent common ownership.

[8] The number of group employees based in the foreign jurisdiction must be at least 25% of the total number of group employees as of the "applicable date" (which generally is the completion date of the acquisition or the last day of the month preceding the completion date of the acquisition). Also, at least 25% of the compensation paid to the group's employees must have been paid to employees based in the foreign jurisdiction during the "testing period," which is one year, ending on the applicable date.

[9] At least 25% of the group's tangible personal property and real property used or held for use in the active conduct of a trade or business must be in the foreign jurisdiction on the applicable date, determined on a gross basis using either adjusted tax basis or fair market value. For this purpose, rental property is included at eight times the net annual rent paid with respect to such property. Note that intellectual property and other intangible assets are not counted for purposes of the asset test.

[10] At least 25% of the group's gross income for the testing period from transactions occurring in the ordinary course of business must be derived from transactions with unrelated customers located in the foreign jurisdiction.

[11] It may be possible to structure an inversion where gain is recognized by the U.S. corporation rather than by its shareholders.

[12] 2009-40 IRB 452, 09/17/2009.

[13] Stock issued in a public offering also is disregarded for purposes of the 60% threshold.