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COMMENTARY

Treasury Releases Significant Temporary Anti-Inversion Regulations and Proposed Earnings Stripping Regulations

On April 4, 2016, the U.S. Treasury Department released two significant packages of U.S. federal tax regulations. T.D. 9761 contains temporary regulations primarily addressing the anti-inversion rules under section 7874 of the Internal Revenue Code, and REG-108060-15 contains proposed anti-earnings stripping regulations that apply generally to related-party debt. Descriptions of the new rules are set forth below.

Temporary Anti-Inversion Regulations

These regulations primarily implement the rules first described by Treasury in Notices 2014-52 and 2015-79 (the "Notices") but also introduce certain new rules and modifications to existing rules that have not been described in any prior guidance.

Under section 7874 generally, a foreign acquiring corporation is treated as a U.S. corporation for U.S. tax purposes if it acquires substantially all of the stock (or property) of a U.S. target corporation and the shareholders of the U.S. target corporation own at least 80 percent of the foreign acquiror stock after the exchange. Although a foreign acquiring corporation remains a foreign corporation for U.S. tax purposes when the U.S. target corporation's shareholders receive less than 80 percent of the foreign acquiring corporation stock in the exchange, section 7874 denies the U.S. corporation use of certain tax attributes when the shareholders of the U.S. target corporation own at least 60 percent, but less than 80 percent, of the foreign acquiror stock after the exchange.

Implementation of Rules Introduced in Notices 2014-52 and 2015-79. The regulations implement the rules introduced in the Notices, which (i) increase the likelihood that in an acquisition of a U.S. corporation by a foreign acquiring corporation, the shareholders of the U.S. corporation will meet or exceed the 60 percent or 80 percent thresholds, invoking the putative rules of section 7874, and (ii) decrease the tax planning that can be undertaken after a 60 percent inversion. Specifically, the regulations include the following.

Rules from Notice 2014-52: For purposes of determining whether the 60 percent and 80 percent tests are satisfied–

- Decreasing the relative size of a foreign acquiring corporation for purposes of calculating the ownership fraction if such foreign acquiring corporation holds a significant amount of passive assets;

- Ignoring certain distributions made by the U.S. corporation during the 36 months preceding an inversion; and
- Subjecting certain types of multistep spin-offs (so-called "spinversions") to section 7874;

For purposes of preventing the U.S. corporation from using the tax benefits resulting from an inversion–

- Treating related-party foreign-to-foreign "hopscotch" loans as investments in U.S. property subject to current U.S. tax;
- Preventing the tax-free decontrolling of a controlled foreign corporation; and
- Prohibiting certain related-party stock sales from being used to strip the earnings of a controlled foreign corporation.

Rules first introduced in Notice 2014-52 that were implemented by the temporary regulations without substantive change are effective for transactions completed on or after September 22, 2014.

Rules from Notice 2015-79:

- Denying the exception to section 7874 for "substantial business activities," unless the foreign acquiring corporation's group has substantial business activities in the country where its parent is tax resident;
- Treating what would otherwise be a 60 percent inversion as a *per se* 80 percent inversion if a foreign corporation and U.S. corporation are each acquired by a new foreign acquiring corporation organized in a third country; and
- Treating "indirect" transfers of property by a U.S. corporation after a 60 percent inversion as if directly made by the U.S. corporation for U.S. tax purposes.

Rules first introduced in Notice 2015-79 that were implemented by the temporary regulations without substantive change are effective for transactions completed on or after November 19, 2015.

New Anti-Inversion Rules. In addition to implementing the rules described in the Notices, the temporary regulations also introduce new rules not contained in any prior guidance as well as substantive modifications to the rules in the Notices. These new rules and modifications to the Notices are effective for transactions completed on or after April 4, 2016.

Chief among the new rules is the so-called "serial inverter" rule. For purposes of calculating the inversion ownership fraction with respect to a new acquisition, this rule generally disregards foreign acquiring corporation stock issued (or deemed issued) in those acquisitions of U.S. corporations occurring within the 36-month period ending on the date a new acquisition becomes subject to a binding contract. These regulations contain an anti-avoidance rule that disregards the termination of an existing contract signed within this 36-month period when the parties to that terminated contract enter into a substantially similar contract outside the 36-month period. This serial inverter rule has the effect of increasing the likelihood that the foreign company shares issued in the new acquisition to the U.S. corporation shareholders will represent 60 percent (and maybe 80 percent) of the adjusted number of outstanding shares of foreign acquiring corporation stock, thus increasing the likelihood that the new acquisition will be subject to the putative rules of section 7874.

For example, assume that foreign Company A is worth $100 in Year 0. In Year 1, Company A acquires U.S. Company B in exchange for $50 of Company A stock. In Year 2, Company A acquires U.S. Company C in exchange for another $50 of Company A stock. Finally, in Year 3, Company A acquires U.S. Company D in exchange for $150 of Company A stock. Absent the serial inverter rule, the Company D shareholders would own $150/$350 or 43 percent of the Company A stock post-inversion. Under the serial inverter rule, Company A's acquisitions of Company B and Company C stock are disregarded when determining whether the Company D acquisition is a 60 percent or 80 percent inversion. As a result, Company A is treated as if it were worth $100 before the acquisition of Company D, and Company D's shareholders are deemed to own $150/$250 or 60 percent of Company A after the transaction, resulting in a 60 percent inversion.

These regulations are temporary and will sunset on April 4, 2019, although it is generally the case that final regulations are issued before a temporary regulation sunsets.

Proposed Earnings Stripping Regulations

In the Notices, Treasury also notified taxpayers that it was considering the issuance of anti-earnings stripping rules to prevent perceived unwarranted base erosion. One of the

purposes of an anti-earnings stripping rule is to prevent U.S. companies from shifting income from high-tax to low-tax jurisdictions through the issuance of debt between related companies (i.e., where the interest on the debt would generate a tax deduction offsetting income taxed at a high rate but would be taxed in a different jurisdiction with a lower rate). These proposed regulations contain those rules, but in a more expansive manner than expected. As drafted, the proposed regulations, issued under the authority of section 385, are not limited to merely earnings stripping arrangements. The regulations apply to a much broader set of related-party transactions. For example, the proposed regulations are applicable to the treatment of debt between both U.S.-to-U.S. related parties (except members of a U.S. consolidated group) as well as U.S.-to-foreign related parties.

Specifically, the proposed regulations (i) require certain related-party debt to be treated as stock of the issuer, (ii) enable the IRS to treat certain related-party debt as partially equity, and (iii) specify due diligence and documentation that must be undertaken and maintained in order for certain related-party debt to be respected as debt for U.S. tax purposes. The effect of the application of these rules would be the denial of any interest deduction taken with respect to recharacterized debt and the recharacterization of payments made on the debt as distributions on stock (potentially treated as dividends for U.S. tax purposes).

The application of the proposed regulations is limited to debts between members of a group (referred to in the regulations as "expanded groups"), which generally include all corporations (foreign and domestic) related through direct, or indirect, stock ownership of 80 percent of the voting power or value. The regulations do not apply, however, to debts directly between members of a U.S. consolidated group.

Recharacterization of Debt Rules. Under the proposed regulations, intercompany debt can be recharacterized as stock if it is issued (i) as a distribution from one expanded group member to another, (ii) as consideration by one expanded group member for the stock of another, or (iii) as boot in certain intergroup reorganizations. Additionally, intercompany debt may be recharacterized as stock when issued with a principal purpose of funding a distribution or acquisition by the funded member, regardless of whether the lending member is a party to such distribution or acquisition. A principal purpose of funding the distribution or acquisition is generally presumed, on a nonrebuttable basis, if the debt in question was issued within 36 months of the distribution or acquisition, subject to a limited exception for debt issued in the ordinary course of certain trade or business activies.

Not all intercompany debt is subject to recharacterization. As mentioned above, debt directly between U.S. consolidated group members is exempt from these rules. Debt distributed by a member is not recharacterized as stock to the extent of the issuer's current year earnings and profits. These rules do not apply to expanded groups if the aggregate issue price of all the expanded group's debt subject to these rules does not exceed $50 million. These recharacterization rules are generally applicable to debt instruments issued on or after April 4, 2016. However, such instruments will continue to be treated as debt until 90 days after the finalization of the proposed regulations, at which time such debt instruments, if outstanding and subject to the recharacterization rule, will be treated as exchanged for stock for U.S. tax purposes. The regulations attempt to prevent some of the negative tax consequences of the deemed exchange, such as preventing cancellation of indebtedness income for the debtor and recognition of gain or loss by the creditor.

Bifurcation Rules. The proposed regulations also enable the IRS (and not the taxpayer) to bifurcate a related-party debt instrument, treating it as partially debt and partially equity where the facts support partial equity treatment. These bifurcation rules, however, apply to "modified expanded groups" by lowering the ownership threshold from 80 percent to 50 percent. These bifurcation rules are generally applicable to debt instruments issued on or after the date that these rules become final.

Documentation Requirements. The proposed regulations also prescribe rules requiring documentation and information that must be prepared and maintained in connection with the issuance of related-party debt between members of expanded groups in order for such debt to be respected as debt for U.S. tax purposes. Generally, the proposed regulations require that such documentation must evidence (i)

the legally binding obligation to pay, (ii) the creditor's right to enforce, (iii) the reasonable expectation of repayment, and (iv) an ongoing arm's-length debtor–creditor relationship during the life of the debt. The proposed regulations require that the documentation be prepared no later than 30 days after the date the debt is issued, except for documentation of the debtor–creditor relationship, which must be prepared within 120 days after the date the debt is issued.

These documentation rules apply to expanded groups that include a member that is publicly traded or have assets in excess of $100 million or annual revenue in excess of $50 million. The rules also provide relief for taxpayers that fail to comply, if such failure is due to reasonable cause. These documentation rules are generally applicable to debt instruments issued on or after the date that these rules become final.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent to our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Andrew M. Eisenberg
Washington
+1.202.879.5576
ameisenberg@jonesday.com

Robert A. Profusek
New York
+1.212.326.3800
raprofusek@jonesday.com

Edward T. Kennedy
New York
+1.212.326.3775
etkennedy@jonesday.com

Scott M. Levine
Washington
+1.202.879.3437
smlevine@jonesday.com