Bold Regulatory Action by Treasury, Hoping to Prevent Inversions and Address Earnings Stripping

On April 4, 2016, the US Department of the Treasury (Treasury) issued temporary regulations that target inversion transactions pursuant to Sections 304, 367, 956, 7701(l), and 7874 of the US Tax Code and proposed "earnings stripping" regulations pursuant to Section 385. This regulation package includes both the long-awaited anti-inversion rules promised in Notice 2015-79 and Notice 2014-52 and brand new provisions not part of those Notices.

In addition to finally implementing the panoply of rules described in the recent anti-inversion Notices[1], the temporary regulations also attempt to limit inversions in several new ways. There is a new rule that prevents a future foreign parent company from serially acquiring US companies in stock based transactions in an effort to "bulk up" and, therefore, satisfy current inversion ownership percentages when it joins in a subsequent US inversion transaction. The rules also require controlled foreign corporations (CFCs) of inverted US companies to fully recognize realized gain upon certain asset transfers to non-CFCs. Finally, the definition of group income in connection with the substantial business activities test is clarified and coordinating rules under Section 956 are part of the new regulations.

Proposed regulations were also issued under Section 385, which has until now been an untapped grant of regulatory authority in the debt-equity area. Section 385 was enacted in 1969, regulations were promulgated and withdrawn in the 1980s, and then it went quiet. Section 385 was amended in 1985 and 1992, but still no new or replacement regulations were promulgated. So for a long time both taxpayers and the IRS have necessarily looked to case law to determine whether an instrument would be characterized as debt or equity for tax purposes. It is interesting that Treasury is only now using this Code section to address earnings stripping transactions – and, importantly, these new rules will potentially affect all inbound investment into the US as they are not limited to post-inversion structuring.

The proposed regulations under Section 385 allow a recharacterization of debt to equity if certain factors are present. For example, any debt that is issued by a subsidiary to its foreign parent in connection with a dividend (and several transactions that are only one step removed from such a distribution) may be treated as stock. An exception to these rules exists for companies that are using the funding for new investment in the US, such as constructing a factory or building. In addition, certain multinational groups must now establish contemporaneous documentation to substantiate their position that a related-party arrangement is debt.

Furthermore, on audit, the IRS has the power under the new rules to recharacterize debt as equity *in whole or in part*, rather than the "all or nothing" approach that has generally been applied historically.

These novel and sweeping rules, issued under a Code section that has been basically dormant since the 1980s, show that the Administration is striving to use every tool at its disposal to address erosion of the US tax base in the face of both recent inversion activity and the trend of foreign acquisition of US companies. Although protection from inappropriate earnings stripping through intercompany debt is something almost every nation addresses in its tax law, this regulatory action, when viewed together with the inversion regulations issued on the same day, could be seen as just another finger in the leaking dike of US international tax policy, aimed at holding things together until more meaningful legislative changes are politically possible at the Congressional level.

Despite the issuance of these new and long-awaited Treasury regulations, Treasury Secretary Jack Lew acknowledged again that the regulations would not fully stop corporate inversions and urged Congress to take action on the matter. At the same time, and not surprisingly, there remains a clear divide between Congressional Democrats and Republicans on what to do next.

Democrats in Congress remain committed to taking legislative action to further curb inversions. In fact, during the first few months of this year, we have already seen the introduction of anti-inversion legislation in both Chambers of Congress by Democrats. Additionally, Senate Finance Committee Ranking Member Ron Wyden (D-OR) is expected to introduce legislation that would make inversions more difficult by making various policy changes, including potentially by addressing: (1) the ownership threshold for inverted companies, (2) hopscotch loans, and (3) "spinversions."

Meanwhile, Republicans in both Chambers remain committed to focusing on overall US tax reform as the way to address the so-called inversion "epidemic." Though each Chamber presently has a different approach, Republicans have suggested that their efforts complement each other and will go a long way to making the US a more competitive environment in which to do business – which they believe is key to keeping US companies from relocating abroad.

[1] See our previous publication on Notice 2015-79: "O Congress Where Art Thou?"

Regardless of these different approaches, it remains unlikely that standalone anti-inversion legislation will move through either Chamber. Perhaps most reflective of the Republican stance on the matter, following Treasury's action on April 4, House Ways and Means Committee Chairman Kevin Brady (R-TX) argued these are "punitive regulations that will make it even harder for American companies to compete and will further discourage businesses from locating and investing in the United States." Moreover, with Senate Finance Committee Chairman Orrin Hatch (R-UT) promising to "carefully scrutinize" these proposals, and Chairman Brady indicating that he plans to "continue reviewing Treasury's new regulations, including…Treasury's authority to issue such sweeping tax changes without consideration by Congress," it is clear that lawmakers remain at an impasse as to the immediate and best path forward.

With significant reforms to US tax laws likely at least (indeed, perhaps more than) a year off and the pressure for congressional action on inversions growing, the timing and substance of any potential anti-inversion legislation will likely be determined in November as the American electorate heads to the polls. This is especially true given that current presidential frontrunners (Hillary Clinton and Donald Trump) target inversions as part of their tax plans. If Democrats are able to maintain control of the White House and take control of the Senate, the anti-inversion landscape could shift dramatically. According to Secretary Clinton, she would have gone further than the Treasury proposals, advocating for an "exit tax" on inverters. On the other hand, a Republican President and Congress could take things in an entirely different direction.

Contact

Linda Pfatteicher
Partner, San Francisco
T +1 415 954 0347
E linda.pfatteicher@squirepb.com

Mitch Thompson
Partner, Cleveland
T +1 216 479 8794
E mitch.thompson@squirepb.com

Matthew Cutts
Partner, Washington DC
T +1 202 457 6079
E matthew.cutts@squirepb.com

Brandon Roman
Associate, Washington DC
T +1 202 457 5330
E brandon.roman@squirepb.com