SQUIRE PATTON BOGGS

O Congress, Where Art Thou? – Treasury Takes More Action on Inversions While They Wait for Congress to Act: Notice 2015-79

With Congress unable or unwilling to act, on November 19, Treasury released Notice 2015-79 (the "Notice"), expanding on and clarifying its September 2014 actions against inversions with the hope of making it less attractive for US multinationals to successfully complete inversion transactions. As some of these provisions are effective immediately, companies currently in the process of inverting may need to reconsider how, or if, they will now invert.

While there was significant speculation that the Notice would include provisions under Sections 385, 163(j) or other authorities in order to address post-inversion earnings stripping, there was no new language included to this effect. Of particular note, during a press briefing on the Notice, Treasury Secretary Jack Lew stated that the administration will continue its efforts, including "action in the coming months," to address the problem of earnings stripping. Secretary Lew stated, however, that without Congressional help, inversions cannot be shut down completely.

Following the release of the Notice, Senator Ron Wyden, the ranking Democrat on the Senate Finance Committee, stressed that action is needed to deal with the "inversion virus that is plaguing the country." In contrast, Senator Hatch, Chairman of Senate Finance, repeated his fear that a "pure anti-inversion approach may have the unintended consequence of encouraging more acquisitions of United States companies by foreign-owned firms." Hatch stressed he believes this is a problem best addressed through a comprehensive tax overhaul with lower corporate tax rates and a territorial system with base erosion protections. Chairman Brady of the House Ways and Means Committee expressed similar sentiments:

> "Inversions are a serious problem that need to be addressed, but even Secretary Lew acknowledges that the only real solution to inversions is tax reform that makes American companies more competitive. Mandating new rules to raise taxes on American businesses simply make them more attractive takeover targets for foreign corporations."

Early indications suggest that the Notice has not moved the needle on Capitol Hill toward immediate legislative action, but certainly Treasury knew that would be the case. So it would seem the main question is whether Treasury's release of the Notice will create enough uncertainty to chill the inversion market for the time being. The "time being" is the operative phrase because as this Administration knows, in about a year this will be another Administration's problem.

Regardless of what Congress does or does not do, here is what companies need to know now about the Notice, which contains seven main points in three categories.

Category 1 contains three points intended to strengthen both the 80% rule and the substantial business activities test. These provisions take effect immediately and will apply to transactions closed as of November 19, 2015 or later.

1. **Third Country Limitation** – In cases where a third jurisdiction (i.e., other than the US and foreign acquirer jurisdiction) is used for the new foreign parent location, the stock of that foreign parent issued to acquirer's shareholders will be removed from the denominator in calculating whether there has been an 80% change in ownership. As a result, it is likely that US shareholders will be treated as owning more than 80% of the new foreign parent after such transactions.
2. **Anti-Stuffing Rule Clarified** – The Notice clarifies that the anti-stuffing rule (which prevents companies from adding certain assets into the foreign acquirer to increase the relative value of the new foreign parent) applies to any assets (including passive assets) acquired for the principal purpose of avoiding the 80% rule.
3. **Substantial Business Activities Test Strengthened** – The Notice states that the 25% business activities exception will only be met if the new foreign parent is a tax resident in the foreign country in which it is organized.

Category 2 contains two points that affect post-inversion transactions and that are effective retroactively to inversions completed on or after September 22, 2014 (the date of the last "inversion notice" from Treasury).

1. **Out From Under Limitation** – The Notice further restricts the ability to use tax attributes to offset inversion gain including deemed dividend income at the controlled foreign corporation (CFC) level. This point is intended to target licensing income generated by the CFC in an effort to effectively transfer the CFC activities out from under the US parent.
2. **Built-In-Gain Trigger** – Inversion gain is triggered when a CFC is transferred out from under the former US parent entity. Previously, such gain was limited to the undistributed earnings of the CFC – the so-called Section 1248 amount. The Notice requires the full amount of all built-in-gain to be recognized with no Section 1248 limitation.

Category 3 contains two clarifications to Notice 2014-52:

1. **Cash Box Rule Limited** – The Notice clarifies that in applying the cash box rule (which requires foreign parent stock attributable to passive assets to be excluded from the 80% test), active insurance assets will not be included.
2. **Reduction in Size Prohibition Limited** – Prior to the Notice, any extraordinary dividends paid by the US parent just prior to acquisition would be disregarded when considering the relative values of the US company and the foreign acquirer for purposes of the ownership test. The Notice clarifies that this rule will not apply when a foreign corporation acquires a US company in an all or mostly cash acquisition.

The divide between Congress and the Administration on how best to address corporate inversions continues to exist. Congressional leaders believe that inversions are really just the symptom of a US international system that has become anachronistic and uncompetitive, which therefore needs an overhaul including rate reductions and the introduction of a more territorial system. The Administration appears focused more keenly on making inversions harder to achieve and more costly to live with afterward, hoping to stem the flow of multinational enterprises out of the US through inversions. Which approach will ultimately prevail will be sorted out over the coming months (perhaps many, many of them!) but in the meantime, it appears we can expect more Treasury action and regulatory pronouncements.

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